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ECONOMIC
OUTLOOK

Chamber of Commerce of the United States

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CAUTIOUS OPTIMISM

by
Richard W. Rahn and Rajni Bonnie Ohri

The U.S. economy remains basically strong despite the fact that some recently released numbers were not very encouraging. Any uncertainty regarding the near term outlook has to do with how individuals and businesses will respond to the tax reform legislation recently enacted. While some analysts worry that the lackluster (0.6 percent) increase in real GNP during the second quarter may foreshadow further weakness in economic activity, a closer examination of the data shows that this is far from the case. The second quarter revisions reinforced the sources of strength: consumer spending grew at a 6.5 percent rate, investment in producers' durable equipment rose by 19.9 percent, and residential investment increased by 13.5 percent. However, the second quarter data also showed a continuing deterioration in the nation's trade deficit. Exports of goods and services decreased by $9.4 billion while imports increased by $18.5 billion, pushing real net exports to a $154 billion deficit.

The near term forecast remains positive. Historically low financing rates produced record high car sales in early September; domestic auto volume soared 36.9 percent from a year earlier, averaging 18.5 million cars sold at an annual rate, in early September. However, the drop off in domestic car sales in the aftermath of the late summer sales incentives was just as pronounced: by mid-September car sales had dropped to a seasonally adjusted annual rate of 11.5 million units. The drop off was larger than many had expected so soon after the introduction of the financing incentives, but it was not surprising in light of the diminishing supply of eligible models. As a result, third quarter sales of cars should average 10.3 million units, significantly above average for the past year. The strength in car sales is translated into a sharp increase (approximately $15 billion) in consumer durable spending during the third quarter. Personal consumption expenditures rose by 1.1 percent in August, led by a 14.8 percent surge in spending on motor vehicles and parts as consumers rushed to take advantage of the record low finance rates offered at the month's end. Auto sales are also being buoyed by forward buying incentives resulting from the tax reform legislation. Because capital cost recovery allowances are less generous under the new tax law, individuals have an added incentive to buy now. This was the largest increase in consumer spending since December 1985. However, since the rise in car sales is almost entirely accounted for by a drop in inventories, it will not be reflected in the third quarter GNP figures.

The surge in domestic car sales has also been reflected in retail sales. Retail sales increased by 0.8 percent in August following a 0.3 percent increase in July. The strength in consumer spending has reflected strong growth in personal income which rose by 0.4 percent in August. The rise in personal income included a 0.7 percent increase in wage and salary disbursements in the manufacturing sector, which had declined in the previous two months. Real personal disposable income rose by 6.4 percent in the first quarter and 7.3 percent in the second quarter. Personal income, particularly the wages and salaries component, should strengthen further to reflect improvements in employment. After declining for three consecutive months, the civilian unemployment rate inched up to 7 percent in September from 6.8 percent in August. The uptick returned the unemployment rate to its June level. The summer drop and subsequent rise in joblessness reflects both faulty seasonal adjustments and increases in the labor force.

IN THIS ISSUE

Cautious Optimism ..... p. 1
Forecast Table ..... p. 2
Industrial Outlook ..... p. 3
Latin American Debt:
Flirting with Disaster ..... p. 15
Trends in Commerce ..... p. 26

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1988
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS										YEARS			
	Actual			Forecast							Actual	Forecast		
	85:4	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4	88:1	1985	1986	1987	1988
GROSS NATIONAL PRODUCT														
Real GNP	2.1	3.8	0.6	2.4	3.7	2.6	2.9	3.8	4.0	4.3	2.7	2.6	3.0	4.3
Consumption	1.7	3.6	6.2	6.6	1.3	2.7	2.1	2.1	2.3	3.3	3.5	4.1	2.9	3.0
Residential Investment	3.4	11.0	14.5	-1.1	-1.4	-1.8	-0.5	4.1	4.7	4.2	3.9	7.6	0.7	5.1
Nonresidential Investment	12.5	-15.1	-0.9	0.0	0.2	1.5	1.1	3.0	2.5	5.0	9.3	-0.9	1.1	4.6
Equipment	18.7	-17.0	19.6	3.8	1.7	1.3	0.0	2.1	1.6	4.7	10.1	4.2	2.6	4.3
Structures	0.3	-10.8	-35.2	-8.7	-3.5	1.8	3.9	5.3	4.8	5.7	7.7	-11.3	-2.5	5.4
Exports	8.2	7.1	-9.8	-1.5	7.5	10.2	10.8	13.3	13.5	13.7	-2.0	0.2	7.5	13.2
Real Net Exports (82$B)	-132.0	-125.9	-153.9	-162.5	-159.4	-149.9	-138.6	-125.9	-114.7	-104.7	-108.2	-150.4	-132.3	-93.6
Imports	23.3	0.2	15.8	5.8	2.7	-0.4	-1.2	-0.4	1.1	2.6	3.8	9.1	1.8	2.4
Government Purchases	22.7	-27.5	11.0	5.9	23.4	-18.5	-0.3	6.1	16.2	-14.5	10.9	3.1	1.8	0.8
Final Sales	2.7	-1.3	3.4	3.9	3.2	1.2	2.9	4.1	4.9	2.9	4.2	2.4	3.0	4.1
Change in Business Inventories (82$B)	-5.2	39.9	15.1	1.9	6.4	19.4	19.4	17.0	9.4	23.1	9.0	15.8	16.3	23.3
Industrial Production	2.0	2.0	-0.9	2.1	4.8	3.1	4.2	6.1	6.7	6.1	2.6	1.8	3.8	6.5
Total New Car Sales (mill.)	10.3	11.0	11.0	13.3	10.7	10.7	10.9	10.8	10.9	11.0	11.2	11.5	10.8	10.8
Domestic Car Sales (mill.)	7.0	7.8	8.1	10.3	7.8	7.7	7.9	7.8	7.8	7.8	8.2	8.5	7.8	7.6
New Housing Starts (mill.)	1.77	2.00	1.91	1.82	1.81	1.75	1.78	1.81	1.82	1.85	1.74	1.88	1.79	1.94
EMPLOYMENT, WAGES AND PRICES														
Civilian Unemployment Rate (%)	7.0	7.1	7.2	6.9	6.9	6.9	6.8	6.8	6.6	6.4	7.2	7.0	6.8	6.2
Compensation	3.7	3.0	2.3	2.6	2.5	3.6	2.6	2.7	2.9	3.3	4.0	3.0	2.8	3.1
Productivity	-3.4	4.3	-0.4	0.3	1.3	0.6	0.9	1.4	1.4	1.4	0.5	0.8	0.8	1.4
Unit Labor Costs	7.3	-1.3	2.7	2.3	1.2	2.9	1.7	1.3	1.4	1.8	3.7	1.2	1.9	1.9
Consumer Price Index	4.3	1.4	-1.7	1.5	2.4	2.5	2.6	2.8	2.9	2.8	3.5	1.7	2.2	3.0
Implicit GNP Deflator	3.6	2.5	1.8	1.8	1.3	1.7	2.0	2.3	2.5	2.6	3.3	2.5	1.8	2.6
Prime Interest Rate (%)	9.5	9.4	8.6	7.8	7.1	6.8	6.3	6.2	6.2	6.2	9.9	8.2	6.4	6.2
3-mos. Treasury Bill Rate (%)	7.2	7.0	6.1	5.4	5.3	5.2	5.2	5.0	4.9	4.9	7.5	6.0	5.1	4.7
Corporate Bond Rate (%)	10.6	9.6	9.0	8.8	8.6	8.1	7.7	7.3	7.2	7.1	11.4	9.0	7.6	6.8
Real Personal Disposable Income	2.8	6.4	7.2	0.6	1.6	4.6	1.5	1.9	2.0	9.3	1.4	3.4	2.6	3.9
Profits from Current Production ($B)[1]	189.2	207.3	199.9	190.5	197.3	158.7	160.0	185.0	190.5	187.8	189.0	198.7	173.5	195.7
GOVERNMENT FISCAL POLICY ($B)[2]														
Unified Receipts											736	769	830	925
Unified Outlays											937	993	1020	1083
Unified Deficit											-201	-224	-190	-158

[1]After-tax corporate profits with inventory valuation and capital consumption allowances.

[2]Unified budget figures on a fiscal year basis.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's outlook contains the August revisions to the National Income for the second quarter of 1986. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 13.7 percent during 1986, 8.4 percent in 1987, and 5.9 percent during 1988. The trade weighted exchange value of the dollar falls by 17.3 percent in 1986, 3.0 percent in 1987, and 3.0 percent in 1988. The price of imported oil averages $14.00 per barrel in 1986 and $15.00 per barrel in 1987 and 1988. The federal minimum wage is not expected to increase.

Housing starts rose 0.4 percent in August to a 1.82 million seasonally adjusted annual rate. Starts should average 1.8 million units for 1986 as a whole, up from 1.7 million units in 1985. In spite of the slowdown in second quarter GNP growth, the housing market has been able to maintain a very healthy level of starts, consistent with demographic and replacement demand. Spurred by low interest rates and increased incomes, residential investment continues to rise. We expect that the current pace of housing activity will continue during the next two years.

While several factors, including moderate wage increases, low levels of capacity utilization and the drop in oil prices will help hold the line on consumer price increases, the decline in the value of the dollar is likely to offset somewhat these downward pressures. Higher import prices should contribute to a steady, albeit slow, acceleration in prices during 1987. The impact of higher priced imports is reflected in the difference between the rise in the consumer price index (CPI), which includes imported products, and the implicit GNP deflator which does not. The overall price level, as measured by the GNP deflator, is anticipated to rise by only 1.8 percent this year, and 2.6 percent in 1987, while the CPI is expected to rise by 2.2 percent and 3 percent, respectively.

The continued decline in the foreign exchange value of the U.S. dollar is slowly being translated into a rebound in U.S. export growth. Indeed, the monthly merchandise trade deficit improved in August, declining to $13.3 billion from its July peak of $18 billion. The decline in the deficit was largely due to an increase in agricultural exports (the first since April), and a substantial decrease in imports of manufactured goods. A steady decline in the rate of growth of imports should become evident as U.S. economic activity settles into a more moderate rate of growth and the demand for imports subsides. Similarly, the improved price competitiveness of U.S. exports and stronger growth abroad should spur the growth of exports.

The data presented not only shows that the U.S. economy is performing well but that prospects for the remainder of this year and next remain strong. In addition to tax reform, the outlook will be shaped by the impact of low oil prices, the decline in the value of the dollar and low interest rates. The stimulus from these factors will gather momentum toward the end of the year. Real GNP is expected to rise by 3 percent in 1987 and 4.3 percent in 1988.

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This month's issue of *Economic Outlook* is devoted to the Chamber's annual analysis of the prospects for U.S. industry. In keeping with recent concerns regarding the impact of foreign competition on U.S. industry, the industrial outlook details how some industries have met this challenge, and provides a forecast of industrial production and employment for 1987.

INDUSTRIAL OUTLOOK

by
Rajni Bonnie Ohri

Economic growth is an uneven process, invariably accompanied by a gradual shift in the composition of economic activity. Changes in the composition of output and employment also occur as some industries adapt more successfully than others to the changing economic environment. Thus, even during periods of general economic expansion some industries will grow slowly or stagnate, while others decline. Indeed, the expansion of the rapid-growth industries depends partially on the release of resources from contracting sectors.

The factors shaping the present character of American industry vary from industry to industry. For instance, the decline in world oil prices has benefited some industries (i.e., plastics and transportation equipment) and wreaked havoc upon others (i.e., oil field machinery). And the problems facing American agriculture have had repercussions throughout the agricultural equipment and chemicals sectors. However, two major changes in the economic environment have had a significant impact on the performance of and the outlook for every one of the nation's industries. These are technological advancements and innovations, and increased foreign competition. The winners of this new industrial revolution will be those industries and firms that adapt successfully to this competitive environment.

A new era of manufacturing is emerging. Thanks to technological advances, American firms can now turn out a greater diversity of products and product models to satisfy the needs of its customers. Nowhere is this fundamental change more evident than in the automobile and textile industries. Pinned against the wall by foreign competition, U.S. automakers have made an industry-wide commitment to high technology, building new factories and modernizing the old ones, thereby increasing efficiency, labor productivity and product quality. The trend is now spilling over to the suppliers of parts to auto firms. But the changes do not stop at the factory gate. This new competitive atmosphere has translated into im-

proved consumer services, including performance guarantees and financial services. Thus, today U.S. auto buyers do more than test drive different car models and compare standard equipment; they also compare service quality.

In the textile industry, which has suffered extensive damage through competition from imports, new generation machines clean cotton and other fibers ten times faster than was possible a decade ago. Looms produce a hundred yards of cloth an hour – twice as fast as ten years ago. In addition, textile firms are dropping unprofitable product lines and concentrating efforts in the manufacture of those products where they can compete more effectively.

In the footsteps of these industries, other major firms that are aggressively pursuing high technology include heavy equipment manufacturers and machine tool builders. Throughout the heavy equipment industry – at Caterpillar Tractor, Navistar, and others – advanced technology is coming on apace. Machine tool builders have stepped up their interest in innovation after watching their traditional dominance of the world market slide into a net trade deficit. Their newly aroused concern has coincided with the availability of low cost electronics, which has made possible the incorporation of sharply improved capabilities into their products.

Until recently, American industry had not recognized the full potential of foreign markets. Only now have specific industries and firms begun to embark on vigorous export programs and reap the potential benefits. Because of the large size of our domestic market, many companies, in the past, felt less urgency about opportunities abroad and failed to make the sustained investments needed to develop overseas markets. However, as we discussed in last month's issue of *Economic Outlook*, the decline in the value of the dollar opens up new markets for U.S. goods, both for domestic companies that were already exporters and for those who had not previously explored the possibility.

For the past few years, U.S. industry has been engaged in a massive drive to lower the costs of doing business. This has been achieved through a variety of options, such as outsourcing, closing inefficient plants, or opening plants abroad. Companies realize that in order to stay competitive, they must adapt to the new competitive environment and continue to innovate with new products and marketing strategies. Industries may revitalize domestic operations through infusions of Japanese management and production technology; they can also hammer down wage costs by farming out production jobs and buying services from outside vendors. Others find it more beneficial to ride the merger wave and shuffle existing assets than to raise capital to invest in new plant and equipment.

Industrial Production, Employment and Trade

Industrial production is anticipated to increase by 3.8 percent in 1987 following an estimated increase of only 1.8 percent in 1986. Production in the manufacturing sector is expected to post a 3.4 percent increase, with both the durable and nondurable sectors sharing in the improved performance. After years of flat growth, output of textile mill products is expected to rise by 7.7 percent. The leather and products industry, however, will continue to experience output declines, dragging down industry performance (see Table 1).

TABLE 1

INDUSTRIAL PRODUCTION BY INDUSTRY
1985-1987
(Annual Rates of Change)

	1985(a)	1986(e)	1987(f)
Total Production	2.3%	1.8%	3.8%
Manufacturing	2.6	1.5	3.4
Nondurables Manufacturing	2.4	3.6	3.7
Food & Products	3.1	3.2	4.2
Tobacco Products	-0.7	-2.3	-0.2
Textile Mill Products	-1.1	7.7	2.3
Apparel Products	-1.1	3.3	1.6
Paper & Products	0.2	4.4	3.7
Printing & Publishing	4.9	2.9	3.6
Chemicals & Products	4.4	3.9	4.0
Basic Chemicals	-0.5	-0.7	5.0
Petroleum Products	-0.8	5.4	3.3
Rubber Products	2.5	3.1	5.6
Tires	-3.0	-4.3	5.7
Leather & Products	-7.5	-8.8	0.3
Durables Manufacturing	2.8	0.0	3.2
Lumber & Wood Products	3.6	6.6	0.1
Furniture & Fixtures	3.7	3.6	-0.9
Stone, Clay & Glass Products	2.3	3.6	-1.0
Primary Metal Products	-1.9	-2.4	3.3
Basic Steel & Mill Products	-3.1	-0.6	2.4
Fabricated Metal Products	5.0	-0.7	0.1
Nonelectrical Machinery	3.2	-2.2	5.7
Metalworking Machinery	5.1	2.0	4.2
Office & Computing Machines	5.5	-2.3	7.0
Electrical Machinery	-1.8	-1.4	5.3
Transportation Equipment	8.5	2.0	2.1
Motor Vehicles	8.6	-3.6	-4.5
Instruments	2.2	2.3	5.2
Miscellaneous Manufactures	-1.3	1.4	1.7

(a) Actual (e) Estimate (f) Forecast

Source: U.S. Chamber of Commerce, Forecasting Section, using the Data Resources, Inc. macro model of the U.S. economy.

Reflecting the economic expansion, total nonfarm employment, which rose by an estimated 2.5 million jobs in 1986, should increase by an additional 2 million jobs in 1987. After falling by a projected 0.3 percent this year, manufacturing employment should resume modest growth in 1987, with the nondurable manufacturing sector being the strongest source of job growth (see Table 2). Outside of manufacturing, the strongest source of new

TABLE 2

EMPLOYMENT BY INDUSTRY
1985-1987
(Annual Rates of Change)

	1985(a)	1986(e)	1987(f)
Nonfarm, Total	3.3%	2.8%	2.0%
Manufacturing	-0.3	-0.3	0.6
Nondurables Manufacturing	-1.0	0.7	0.9
Food & Products	-0.3	1.8	0.6
Tobacco Products	0.8	-4.9	-4.2
Textile Mill Products	-5.7	0.8	2.2
Apparel Products	-5.1	0.1	0.4
Paper & Products	0.3	1.0	0.7
Printing & Publishing	4.3	3.1	0.9
Chemicals & Products	-0.3	-1.6	1.0
Petroleum Products	-6.1	-6.2	3.5
Rubber Products	1.2	1.6	0.7
Leather & Products	-12.5	-5.9	0.8
Durables Manufacturing	0.1	-0.9	0.5
Lumber & Wood Products	-0.4	3.6	3.0
Furniture & Fixtures	1.3	0.9	-1.4
Stone, Clay & Glass Products	-0.4	1.9	1.1
Primary Metal Products	-5.2	-4.3	-1.1
Fabricated Metal Products	0.3	-1.4	-0.5
Nonelectrical Machinery	-0.7	-3.6	1.0
Electrical Machinery	0.4	0.4	0.4
Transportation Equipment	0.4	0.4	0.4
Instruments	0.4	0.4	0.4
Miscellaneous Manufactures	-3.5	0.2	-0.1

(a) Actual (e) Estimate (f) Forecast

Source: U.S. Chamber of Commerce, Forecasting Section, using the Data Resources, Inc. macro model of the U.S. economy.

TABLE 3

EXPORTS AND IMPORTS BY INDUSTRY
(Percent Change)

	EXPORTS			IMPORTS		
Industry	1984	1985	1986(a)	1984	1985	1986(a)
Food & Products	0.4%	-9.1%	7.7%	16.4%	4.1%	-1.2%
Tobacco Products	-0.6	6.3	31.1	8.3	-11.4	2.0
Textile Mill Products	-1.2	-5.2	8.7	37.4	4.2	19.8
Apparel Products	-4.4	-4.3	15.5	39.7	12.2	15.2
Lumber and Wood Products	-5.3	-1.1	5.6	9.3	5.5	12.0
Paper & Products	5.3	-10.1	6.9	30.9	1.0	2.8
Printing & Publishing	4.2	-9.3	-1.8	34.6	12.2	28.5
Chemicals & Products	15.0	-3.7	-0.6	28.2	6.8	5.4
Petroleum Products	-8.9	6.2	-25.4	-1.7	-10.2	-23.9
Rubber Products	5.8	-5.8	2.2	44.5	8.2	13.3
Leather & Products	15.2	-9.1	-9.0	28.0	13.6	18.1
Leather Footwear	-11.4	-17.7	3.9	27.2	37.6	14.9
Construction Materials	-14.2	-12.6	-8.1	75.8	53.4	15.6
Metalworking Machinery	4.4	9.8	5.5	50.8	27.9	23.0
Electronic Components	19.1	-2.4	7.9	46.1	83.6	23.8
Industrial Electronic Equipment	-1.2	-9.9	-9.2	29.9	-11.6	10.4
Computers	28.0	3.7	-6.2	na	na	na
Motor Vehicles	16.1	21.8	9.5	27.2	24.4	27.3
Instruments	2.6	-0.4	2.7	36.8	-13.8	25.6
TOTAL	11.2	-0.5	1.6	20.7	6.5	-6.2

(a) Data for 1986 is only available through the month of July. To calculate the rate of growth for 1986 the value of exports and imports for the first 7 months of the year were compared to the same period in 1985.

na not available.

Source: U.S. Department of Commerce.

jobs in 1987 is anticipated to be the finance, insurance and real estate industry, where employment is forecasted to increase twice as fast as total nonfarm employment.

An examination of the 1986 pattern of exports and imports reflects a steady decline in the rate of growth of imports (see Table 3). However, the problem in the foreign trade sector remains the performance of real exports. Nevertheless, with the continued slide in the value of the dollar in foreign exchange markets, total exports next year are expected to increase while import growth subsides. Total exports should rise by an estimated 1.6 percent this year while imports should fall by over 6 percent.

Industries such as tobacco, electronic components, computers, and apparel will enjoy substantial improvements in export performance this year. Many other industries (crude petroleum, construction materials, food products and electronic components), are expected to experience a slowdown in the rate of growth of imports in 1986 compared to 1985.

The remainder of this article discusses how specific events and decisions have served an important role in determining each industry's performance and presents our outlook for industrial production and employment next year.

Industry Detail

Construction

The construction sector is expected to exhibit modest growth in 1987, albeit down from the robust pace of the last two years. Although construction activity remained strong throughout 1986, residential investment is expected to increase by only 0.7 percent next year while investment in nonresidential structures falls by 2.6 percent as growth in office and commercial construction slows. Construction of retail facilities, because it is linked closely to homebuilding, will continue to grow but at a slower pace than previous years, as new housing starts average 1.8 million units next year.

Educational and medical facilities, gas utilities and

telecommunications are expected to be the most rapidly growing segments of nonresidential construction projects next year. However, this sector is primed for significant adjustment since office space has been overbuilt in many regions of the country, where vacancy rates reach as high as 18 percent. Since office buildings constitute a significant proportion of nonresidential construction, the downturn will have a large impact on total construction. Public works construction will continue to increase throughout next year, with the biggest gains in road building, water supply and military construction.

Although employment in the construction industry should increase by an estimated 5.5 percent in 1986, it is anticipated to decline by 1.3 percent in 1987. Despite the recent moderation in wage increases, construction has remained one of the highest paying industries, as measured by average hourly earnings. Aided by belt-tightening measures taken this year, home builders' profits are anticipated to increase in 1987.

Declining interest rates and inflation, rising availability of credit and confidence in the economy are important determinants of the strength and mix of residential construction activity in 1987. More importantly, the effects of tax reform on the real estate sector will have a significant impact on both the primary and secondary mortgage markets. Under the new package, the rental cost of capital on residential building increases significantly. During the first year of enactment, this may depress commercial market demand and property values, resulting in a reduction in office buildings and apartments, and therefore, construction activity.

Lumber and Wood Products

The increase in residential construction activity in 1986 created a strong demand for wood and lumber products. Industrial output of lumber and wood products will rise by an estimated 6.6 percent this year, but production should rise by only 0.1 percent in 1987 as growth in residential investment increases at a slower pace, and the decline in nonresidential construction continues. Profits, however, are expected to decline next year because of lower prices for wood products, weakness in pulp markets and competition from Canadian imports.

Overall, second quarter 1986 industry earnings registered modest gains, but Canadian imports (which have captured 35 percent of the U.S. market) continue to displace domestic products, contributing to excess supply and depressed prices. Although there has been no significant increase in the industry's overall import penetration ratio, a growing proportion of domestic demand is being met by Canadian imports. As a consequence, a serious confrontation over Canada's growing raw timber exports to the U.S. has developed. Another factor contributing to oversupply was preventive harvesting last year to avoid pest damage.

In response to the growing pressure from imports, firms such as Georgia-Pacific Corporation, are streamlining operations, modernizing equipment and specializing in areas where imports have not yet made significant inroads. The firm is substantially increasing its production of low-cost substitutes for plywood – a sizable market in which the Canadians do not compete aggressively. Many companies also hope to enter the booming market for remodeling and repair, which now consumes about 20 percent of lumber production.

The industry is counting on gains from the continuing drop in the U.S. dollar, which should boost lumber and wood exports to Japan, China and Europe. Indeed, according to the American Paper Institute, exports of wood pulp have risen by 20 percent since the beginning of 1986 from the same period in 1985. However, pressures from Canadian competitors will probably not ease because the U.S. dollar has not weakened significantly *vis-à-vis* the Canadian dollar.

Stone, Clay and Glass

As with the lumber and wood products industry, the fortunes of the stone, clay and glass sector are also tied to residential construction activity. Consequently, as residential construction exhibits slower growth next year, industry output will decline by 0.1 percent. Employment, however, is anticipated to rise by 1.1 percent in 1987. Declining raw material prices and lower energy costs have boosted industry profits substantially.

Output of cement and structural clay products, used extensively in residential construction, is expected to fall by 6 percent next year, after rising by an estimated 11 percent this year. The cement industry is still feeling the impact of the dollar's strength as foreign competition continues to depress domestic prices. Similarly, clay imports from Mexico and Canada have become a problem for some U.S. producers serving border areas.

Following several years of declining profits and a shrinking market share, the glass container industry is implementing cost cutting measures and improving operating rates and productivity in order to boost output. Industrial production of glass and glass products is expected to rise by 2.5 percent in 1987, following a projected 5.8 percent increase this year.

Nonferrous Metals

After little growth in 1986, rising demand in the automotive and capital goods industries should contribute to a 3.3 percent increase in nonferrous metal production in 1987. After rising this year, industry profits should continue to increase in 1987 as the benefits of cost cutting programs offset lower prices at major companies.

The industry, which includes producers of nickel, lead,

zinc, copper and aluminum, is still beset with problems that made the last recession the worst in its history. The nonferrous metals industry continues to be battered by low prices, global excess capacity and foreign competition. It also faces special problems which are independent of general business conditions, such as substantial downsizing and substitution of new and lighter materials in construction and in the production of autos and heavy equipment. Lead producers, for instance, have suffered as a result of the elimination of the product from paint and gasoline. In addition, fiber optics are expected to make increasing inroads into the copper cable market, further retarding the demand for copper. Zinc is enjoying increasing usage in the automotive, appliance and construction industries, which account for over 70 percent of all zinc produced. Galvanizing will continue to be the largest application for zinc, although competition from other protective coatings will intensify.

Lower prices and severe competition from imports have led many nonferrous metals producers to diversify and significantly reduce costs. Producers are shifting their emphasis to precious metal and energy-related production. Companies have lowered production costs by combining substantial overhead and personnel reductions with new, more efficient production processes.

The positive impact of the dollar decline has already been felt by some aluminum producers. During 1986, aluminum imports fell by an estimated 4 percent while exports rose by 23 percent, and further increases in export shipments are expected next year. As a result, Alcoa and other aluminum producers have raised effective prices on some of their most widely used products. Producers are concentrating their efforts on developing more sophisticated aluminum products for use in everything from aircraft fuselages to computer chips. Alcan, for instance, is now in the process of developing aluminum-powered batteries and aluminum-coated hard-disk drives for computers. Increasingly, companies are producing primary aluminum facilities abroad where advantages, such as inexpensive power, proximity to raw materials and growing markets, exist.

Industry officials do not expect any significant increase in the demand for copper next year. A worldwide oversupply of the metal persists, continuing to depress prices. The major producing countries, Chile, Peru, Zaire, Zambia and the Philippines, all of which are heavily in debt, are unwilling to cut production because copper is their main source of foreign exchange earnings. Domestic copper producers have made considerable progress in cutting production costs, closing over 50 percent of their idle capacity and reducing the workforce. In spite of the Japanese demand for copper concentrates (for which there is a relatively high industrial demand) supply of copper still exceeds demand.

Iron and Steel

The current depressed conditions of the steel industry can largely be attributed to the long-term decline in the steel intensity of the U.S. economy and the highly competitive trade environment. Although the Administration's import restraint program is intended to alleviate the steel trade problem, imports continue to pour in, capturing 23.8 percent of the domestic market in 1986. Worldwide steel capacity continues to exceed demand. This imbalance has led to intense competition among nations for market shares, which in turn has contributed to sharp declines in the prices of steel products. As a result, profitability has suffered, and in steel producing nations, unemployment, plant closings and painful restructuring are common.

Steel consumption in the U.S. depends primarily on the demand for durable goods such as construction machinery, appliances and autos. Steel has become a less important component of the productive process, in part because of product substitution (in some cases, plastics are substituting for steel) and more importantly, because of the steady shift away from goods produced by heavy industry towards electronics, services and information processing. Finally, even in industries where steel remains a key input, such as autos, improvements in design have reduced the amount of the metal needed. In 1973, for example, 14.5 million cars and trucks were sold, and the U.S. industry used 23 million tons of steel. Last year, 15.7 million vehicles were sold, and only 13 million tons of steel were used. As a result, U.S. producers are forecasted to ship only 70 million tons of steel in 1987, down 5 percent from this year's level.

Individual companies will continue to compete for additional market share next year, especially in plate, large structural and tubular product lines, where slack capacity is the greatest. Improved efficiency and productivity are being realized through mergers, consolidations, and joint ventures. Increasingly, these arrangements are international in scope. For example, LTV and Sumitomo Metals Industries of Japan have formed a joint venture which is scheduled to begin producing electrogalvanized steel by next year. Last year, Inland Steel began discussions with Mitsui for equity participation in a steel mill.

There is also the ongoing process of further cost-cutting, including employment reductions and the installation of more efficient high-tech equipment to improve productivity and quality. Computerized production has reached 99 percent at one of USX Corporation's plants and automation is increasing at other sites. To compete with substitutes such as plastics and aluminum, which are making inroads into traditional steel markets, many steelmakers are diversifying into new markets as illustrated by the merger of USX Corporation and Texas Oil & Gas Corporation.

In the past fifteen years, minimills have captured 20 percent of the steel market, largely in wire rods and bars. A rush of new entrants into this sector, however, has resulted in excess capacity. The minimills are continuing to move into more profitable lines such as the flat hot-rolled steel market which is used for barrels, bridges and casings for industrial machines and equipment.

Industry production should rise by 2.4 percent in 1987. However, because industry wages are 50 percent higher than the national average, employment is expected to remain flat as producers attempt to contain costs and boost productivity.

Nonelectrical Machinery

The nonelectrical machinery industry has not escaped the problems of weak demand and foreign competition that continue to plague a large number of the nation's industries. Although the import penetration ratio for the industry as a whole stands at 17 percent, this overall average conceals major differences between categories within the sector. There is virtually no foreign competition in the domestic market for some industries such as oil field machinery (whose import penetration ratio is only 1 percent) and internal combustion engines (2 percent). However, other industry sectors, including farm machinery, machine tools, and textile machinery, face import penetration ratios of 20 percent, 53 percent, and 40 percent, respectively.

In an effort to meet the challenge from foreign suppliers, the industry has increased purchases of capital equipment to modernize existing facilities. Other efforts to improve international competitiveness include offshore purchases, joint ventures, licensing arrangements and increased spending on research and development. For example, Warner & Swasey has an agreement with Murata of Japan to build lathes and other machines to their specifications. Caterpillar Tractor Company is involved in a joint venture with Mitsubishi Heavy Industries Ltd. to manufacture hydraulic excavators. Caterpillar has recently unveiled a new line of bulldozers and diesel locomotive engines.

Unprofitable operations and continuing pressure from imports have led to several plant closings and consolidations. Nearly one-half of all U.S. machine tool companies now import either components or complete machine tools in an effort to cut costs and become more price competitive. Indeed, machine tool makers, Cross & Trecker and Ex-Cell-O, are in the midst of closing plants to reduce production capacity and are improving the overall efficiency of their operations. Many U.S. companies also supply the needs of third markets from their overseas manufacturing subsidiaries. Lift-truck makers Yale Materials Handling Corporation and Hyster Company rely heavily on offshore production. However, the weakening U.S. dollar relative to the yen and other foreign currencies should help nonelectrical machinery export sales and stem the severe price-cutting wars within the industry. Hale Fire Pump Company has increased its overseas sales force as export orders picked up this year. Cincinnati Milacron Inc., the nation's largest machine tool concern, is slowly gaining market share and reports that orders are up 11 percent from a year ago.

Demand from the auto and defense industries should remain strong in 1987. The continued trend towards automation will increase the demand for machine tools linked by computer control. Similarly, the demand for robots should continue to grow. Over 20 percent of crane builder Harnischfeger's customers increased orders for automated factory systems. Technology will remain a key factor as the industry continues to search for even more efficient applications of the computer to machines and industrial processes.

Sales of U.S. farm machinery will continue to sag in 1987 as depressed commodity and land prices reduce demand. Only two major farm tractor producers, Deere & Company and J.I. Case, remain as major producers in the U.S. industry, down from seven in 1982. Most farm equipment companies have made substantial cost reductions in all of their production and management operations, while others have either closed down plants or left the business altogether. International Harvester Company (now Navistar) has sold its troubled farm equipment unit to Tenneco. As a result of this industry restructuring, production of farm equipment should rise by 3.3 percent in 1987.

For the nonelectrical machinery industry as a whole, production is anticipated to rise by 5.7 percent in 1987. Industry employment is expected to increase only slightly in 1987, after a projected decline of 3.6 percent this year.

Computers

The U.S. office equipment industry has enjoyed substantial expansion in recent years, with output growth increasing by over 13 percent per annum since the beginning of the recovery. Although its prospects remain good, many of the sectors within the office equipment industry have undergone significant changes.

The production of office equipment is anticipated to rise by 7 percent next year. This compares to a 21 percent increase in 1984, when the famous high-tech Silicon Valley area was a strong source of new jobs and new companies. However, in the last two years, signs of a slowdown have become evident. Electronics companies are facing saturated markets and mushrooming foreign competition. As a consequence, industry employment is anticipated to grow by only 4.1 percent in 1987. So far this year, Wang laid off 1,600 workers; Data General dismissed 1,050

employees; and Apollo slashed payrolls by 300 workers. Dozens of companies have forced employees to take pay cuts and pay freezes, unpaid vacations, early retirement, and four day workweeks in an attempt to reduce payrolls and inventories. Such factors as overcrowded markets, excessive domestic production costs and severe import competition are structural problems that will affect the industry's outlook next year.

The improvement in the outlook for the computer industry depends, in large part, on the declining value of the dollar. Already, computer makers have reported a surge in export sales. Prime Computer Inc. attributed 30 percent of its first half earnings to the declining dollar. Computer manufacturer Hewlitt Packard has taken advantage of the cheaper dollar to slash its European and Japanese selling prices by as much as 30 percent. This has resulted in a 51 percent increase in export sales for the first 9 months of 1986. Although IBM's U.S. sales may be flat, the company reports that overseas sales are running 20 percent ahead of last year. In an effort to remain competitive, computer equipment manufacturers have established their production facilities offshore, not only to serve foreign markets but also to produce goods for the U.S. market. Corona Data Systems, a desktop computer maker, has cut costs by 42 percent since it moved production facilities to South Korea and Japan.

While the sales growth of personal computers is abating, demand for computer work stations—extra powerful personal computers for engineers, scientists and other professionals—has increased. The minicomputer market, however, has been squeezed by cutbacks in corporate computer buying and the spread of desktop office computers. Growing interests by consumers in the educational and home computer markets will contribute to the growth of personal computers. In an effort to remain competitive, companies are introducing new models of business computers, developing new market strategies and reducing prices in hopes of increasing sales. Honeywell is among the many computer concerns turning to so-called "vertical marketing," tailoring sales efforts to the special needs of different industries. Digital Equipment Corporation has spent two years overhauling its aging line of minicomputers; as a result, sales rose by 14 percent in 1986. Texas Instruments is focusing on advances in artificial intelligence and industrial automation.

Electrical Machinery

The near term outlook for the electrical machinery industry calls for modest growth in 1987. Industrial output and employment is anticipated to increase by 5.3 percent and 0.4 percent, respectively.

Although within the industry there were bright spots in the defense and consumer products categories, depressed sales in the industrial components sector, especially semiconductors, dragged down overall industry performance. Semiconductors, which made the greatest contribution in technical and economic terms to the industry, have suffered a sharp turnaround from its spectacular advance in 1984. It continues to suffer from reduced demand, depressed prices, high inventories and excess capacity. Foreign competition, especially from Japan in high-volume semiconductor segments, has pushed import penetration ratios as high as 39 percent of the U.S. market. However, in July, the U.S. concluded a trade agreement on semiconductors with Japan designed to cut Japanese dumping and increase the U.S. share of the Japanese chip market. Indeed, National Semiconductor Corporation recently signed an agreement with NMB Semiconductor Company, a Japanese chipmaker, to design, make and sell computer chips in Japan. And, Texas Instruments and Motorola are among the first to have built electronics plants in Japan.

In an effort to solidify their presence in the U.S. market and guard against the possibility of protectionist policies, Japanese producers are increasing joint ventures with U.S. firms. Several Japanese electronics firms have announced plans to acquire U.S. concerns, to expand U.S. operations, or start new product lines at existing U.S. plants. Mitsubishi Metal Corporation, a Japanese producer of semiconductor equipment, plans to acquire California-based Siltec Corporation in order to expand production of silicon wafers. In May, NEC Corporation, a Japanese electronics firm, finished construction of a fiber optics facility near Portland, Oregon. And, Matsushita Electric Industrial Company, Japan's largest electronics firm, plans to build two plants in the U.S., one in Washington and another in Georgia.

Demand from the defense, telecommunications, and aerospace industries should prove strong in 1987, igniting the broad and gradual recovery in the electronics industry. A strong consumer sector should support demand for household appliances; however, some categories, such as T.V. and radios will continue to face severe import competition. Although the dollar's decline relative to the yen will result in higher prices for Japanese products (Sony Corporation recently raised prices by 5 percent on its entire line of color T.V. sets), and lower imports from Japan, imports from newly industrializing countries, such as South Korea, whose currency is linked to the dollar, will rise.

Transportation Equipment

In the years following the 1979 energy crisis, the combination of a major shift in consumer demand, sluggish economic conditions and intense foreign competition plunged the transportation equipment industry into the worst crisis in its history. Three problems in particular—high U.S. labor costs, uncompetitive product quality, and shortcomings in management practices—placed domestic

producers at a serious disadvantage in relation to their Japanese counterparts. In responding to these critical challenges, the industry has made dramatic changes which include restructured product lines, modernized factories, and streamlined production processes. In doing so, it has increased productivity, reduced costs and improved product quality. Between 1978 and 1986, the domestic industry invested over $84 billion in new plant and equipment.

The transportation equipment sector tends to be one of the most cyclical sectors in the U.S. economy and, as a result, it has benefited significantly from the economic expansion. Industry production is projected to increase by 2.1 percent in 1987. The motor vehicles sector is expected to post a slower rate of growth next year while the production of aircraft and railroad equipment should enjoy substantial increases. The aircraft industry is anticipated to increase production by 8 percent in 1987 as airlines expand capacity in efforts to compete for traffic volume.

Long-term industry growth will largely be determined by the degree of success in implementing new technologies designed to speed up production and reduce costs. A majority of the industries comprising the transportation sector continue to face intense foreign competition. Car makers, in an effort to remain competitive with Japanese producers, are adding new high-tech companies to help link design and engineering with production. They are also expanding financial services to facilitate marketing and sales of domestic cars. Domestic car sales are expected to average close to 8 million units next year. However, sales of imported cars are projected to be near 3 million units, accounting for 29 percent of the U.S. market. Although U.S. car sales reached high levels in the summer of this year because of the subsidized interest rates on car loans, the sales promotion was expensive and hurt the earnings of automakers as sales volume did not completely offset costs.

The U.S. auto industry is undertaking new product development and plant modernization of unprecedented scope to regain international competitiveness. They are also engaging in a host of mergers and joint ventures with foreign producers. General Motors Corporation and Sweden's Volvo recently decided to pool their heavy truck operations and form a new company: Volvo GM Heavy Truck Company. As in the electrical machinery sector, foreign automakers are also setting up production facilities in the U.S. General Motors Corporation and Toyota Motor Corporation have formed a joint venture to produce subcompact Novas for Chevrolet in California. Other Japanese automakers that have established production facilities in the U.S. are: Honda Motor Company, Mazda Motor Company, Isuzu Motors Ltd. and Nissan Motors Corporation.

The decline in the value of the dollar has already resulted in price increases for foreign made cars, further increasing the domestic industry's competitiveness. Japanese car makers have boosted prices by an average of $1,027 a car for the 1987 model year. As a result, the inventory of unsold Japanese cars in the U.S. surged by nearly 62 percent at the end of August, compared to a year earlier. Honda Motor Company announced its fourth price increase (4.4 percent) for the 1987 model cars. Volvo also plans to increase prices by 4 percent, but this will depend on the strength of the German mark relative to the dollar because many of the parts used by the Swedish manufacturer are made in Germany.

Moreover, the decline in oil prices is likely to increase the demand for larger automobiles and recreational vehicles, an area where the U.S. still holds a comparative advantage. Compact vans and pickups have retained their popularity because of improved fuel efficiency and their load carrying ability. The U.S. trucking industry, which hauls about 75 percent of the nation's goods, projects that lower diesel fuel costs will save it $7.7 billion next year.

Instruments

The instruments industry, consisting principally of scientific and industrial measurement equipment and consumer products such as cameras, continues to be one of the more profitable manufacturing sectors. Instruments are of major importance in the manufacturing process as they reduce inefficiency and increase both the quantity and quality of the products. Traditionally, the market for instruments reflects the overall level of capital investment in plant and equipment, in combination with the amount spent on research and development (R&D). While the rate of growth in capital investment slowed in 1986, spending on R&D has continued to increase. The trend toward integrating computer technology with instrumentation should continue next year, along with increases in private and public R&D spending.

The continuation in the downward trend in the value of the U.S. dollar and its impact on exports has been a positive development for this industry for which foreign markets, especially in East Asia and Japan, are an important source of revenue. Indeed, the lower value of the dollar has increased export sales at Polaroid by over 40 percent so far this year.

Industry production is expected to increase by 5.2 percent next year, after a projected rise of 2.3 percent in 1986. Workforce reductions over the past few years have contributed to reduced costs. As a result, employment growth is expected to remain flat next year, after rising 0.4 percent this year. Factors that continue to moderate industry growth next year include slow economic growth in our major trading partners, severe liquidity problems that have reduced capital expenditures in developing countries, and the increasing competitiveness of Japanese and European manufacturers.

Food and Products

Changing consumer tastes, demographic shifts and slow population growth signal significant shifts in the structure of the food and products industry over the next few years. Industry production is anticipated to increase by 4.2 percent next year, significantly above the average for nondurable manufacturing as a whole. Many companies are specializing in product lines with high value-added convenience foods whose demand has risen in step with rising consumer incomes and two-earner households. In general, branded products which enjoy strong consumer loyalty have gained market shares, while private-label and generic products have lost shares in virtually all categories.

Increasingly, mergers and acquisitions are changing the character of the American food industry. Last year, the $200 billion a year industry experienced some of the largest takeovers in American corporate history. R.J. Reynolds paid $5 billion for Nabisco Brands; Phillip Morris acquired General Foods for $5.8 billion; and there was a $6 billion leveraged buyout of Beatrice Companies. Other food industry firms were also active in seeking growth by diversification.

Reflecting improving economic conditions and efficiencies accruing from consolidation and concentration, food industry profits will continue to increase in 1987. At many companies, profits were helped by lower commodity prices and interest rates, but hurt by high advertising costs. Earnings on highly processed and specialty foods generally rose, while meat processors' earnings were squeezed by low consumer demand and depressed prices. In today's deflationary environment, food companies are finding it harder to maintain margins by raising prices.

Many companies have already begun to benefit from the decline in the value of the dollar. CPC International, which earns 50 percent of its revenues from abroad, has reported an increase in food export sales for this year. Traditionally, the U.S. has been a net exporter in this industry; however, the surplus is slowly being eroded. After declining by a projected 9 percent this year, exports of food and products are expected to increase by 7.7 percent next year. Imports are anticipated to decline by 1.2 percent in 1987. The U.S. is an importer of high-value-added products, including alcoholic beverages, confectionary products, processed fruit and vegetable products and bakery goods.

Tobacco Products

Continuing public interest to discourage the use of tobacco products, anticipated price increases, and a decline in the number of young people reaching smoking age are expected to further depress the consumption of tobacco products in the next few years. Moreover, the future rate of the Federal cigarette excise tax remains unclear. Given these prospects, cigarette makers are expected to compete aggressively for market share through the introduction of new products and price-related promotional campaigns. In addition, tobacco product manufacturers are likely to seek further industry acquisitions and mergers to offset consumption-related revenue declines. As a result, industry production should show a 0.2 percent decline next year, after falling 2.3 percent this year. Nevertheless, profits have increased substantially this year. Aided by higher cigarette prices and lower unit costs, R.J. Reynolds reported a 21 percent gain in profits in the second quarter of 1986.

In an effort to offset weakening demand, cigarette manufacturers are increasing new product development efforts, acquiring other companies and are experimenting further with price-segmentation techniques. Last year, major developments occurred in the lower priced cigarette segment as the demand for generic cigarettes increased. The Brown and Williamson Company has introduced a new line of generic cigarettes and joined Ligget and Meyers in developing the lower priced market segment. Phillip Morris has introduced a new product whose filter regulates the amount of tar delivered. Product innovations also include longer cigarettes and products positioned to appeal to special market segments such as women and low-tar smokers. Manufacturers have also been developing the emerging value-added market segment; value-added packages contain 25 cigarettes but retail for the price of a 20-count package.

Cigarettes are the major export of the U.S. tobacco industry. The quantity and value of U.S. cigarette exports rose annually through 1981 and then began to decline because of the growing strength of the U.S. dollar and import restrictions abroad. Next year, however, with the lower value of the dollar boosting sales in foreign markets and the reduction in the Japanese tariff, tobacco exports could increase by over 30 percent. On the import side, while foreign suppliers, particularly of cigars and snuff, are making gains in the U.S. market, imports should rise by 2 percent in 1987.

Textile and Apparel Products

The economic fortunes of the U.S. textile industry are closely tied to those of apparel manufacturers. U.S. textile firms sell 50 percent of their output to domestic apparel makers and, in many cases, textile firms also have apparel operations. Overburdened inventories at the retail and wholesale levels, continued increases in imports, as well as sluggish consumer demand, contributed to the sharp drop in industry shipments in 1986. Since 1980, these two industries have reduced employment by over 200,000 jobs and closed over 250 textile mills.

Both the apparel and textile industries have undergone a massive restructuring in an effort to increase both foreign and domestic competitiveness. This has been achieved through the use of "sourcing"—engaging suppliers outside the firm to furnish some or all components at various stages of the manufacturing process. To further increase competitiveness, firms have implemented technological improvements such as the extensive use of computers and better cost control. The traditional ring spinning for yarn, for example, has been supplanted by rotor and friction spinning, which has increased productivity tenfold. Hartmarx Inc., an apparel manufacturer, has begun testing an automated sewing machine which reduces the time spent handling fabric.

Textile and apparel producers have also scrambled to consolidate and shed product lines where they can no longer compete with foreign producers. Industry mergers and acquisitions have allowed firms to concentrate on particular segments of the market. Springs Industries Inc. recently acquired Lowenstein Corporation, thereby creating the second largest U.S. textile enterprise which will specialize in bedsheet production. Cannon Mills Company was acquired by Fieldcrest Mills Inc. in order to strengthen its linens and domestic fabrics division. J.P. Stevens and Company is eliminating its apparel fabrics division in favor of industrial and domestic textiles such as draperies and rugs where substantial growth opportunities exist. And, Collins & Aikman Corporation is concentrating on market niches where imports are vulnerable, such as automotive carpeting and upholstery. Domestic manufacturers are also competing well in the high fashion apparel business which undergoes rapid change. By offering shorter lead times and better quality control than foreign suppliers, domestic firms have sharply improved their competitive edge. The industry is also continuing its $13 million "Buy American" advertising campaign next year.

As a result of these efforts, textile production should increase by 2.3 percent in 1987. Employment is also expected to increase by 2.2 percent next year. Output and employment in the apparel sector is also anticipated to improve in 1987, albeit at a slower pace than textile production. Average hourly earnings in both industries are well below the national average.

The decline in the value of the U.S. dollar is not expected to boost textile and apparel sales significantly since the currencies of the major foreign suppliers of these products (Taiwan, South Korea, Hong Kong, and China) to the U.S. have depreciated an average of only 5 percent against the dollar. U.S. exports of textiles and apparel have suffered and imports have gained, resulting in a 17 percent increase in the industry trade deficit in the first half of 1986 from the same period in 1985.

Paper and Products

Propelled by strong demand, high operating rates and improved earnings, paper producers are expected to increase their capital spending plans in 1987. Responding to tight markets, several companies are in the process of purchasing new machines as well as several new mills. Great Northern Nekoosa Corporation is boosting capacity in its containerboard plants, which have already been operating at 90 percent of capacity for the past two years. Aided by enhanced productivity, the benefits of cost-cutting measures initiated during the recession, and the inherent economies accruing from high operating rates, industry profits should increase further in 1987. Although consumer demand for paper products will not contribute much to industry performance, brisk expansion in business demand should result in increases in production and employment during 1987 of 3.7 percent and 0.7 percent, respectively.

The increase in output, however, will not be uniform among the industry's subsectors. Some segments of the industry, such as uncoated free sheet and linerboard have experienced price weakness and severe competition from imports. However, producers of coated paper and the uncoated free sheet used for computer printouts and copiers will continue to enjoy steady growth. Paper producers are continuing efforts to cut costs and many are converting mills that once produced commodity grades of paper to make higher-margin products. Georgia-Pacific Corporation has converted two facilities that once made market pulp to now produce bleached papers, linerboard and tissue. The largest growth potential for the industry lies in areas such as diapers and sanitary papers, where prices are stabler and demand outruns supplies.

Demand for containerboard, newsprint and business papers is rising rapidly, in part due to increases in overseas orders. Union Camp Corporation reports that its linerboard shipments to Asia and Europe doubled in 1986. Stone Container Corporation finds that exports of linerboard are 60 percent higher than they were a year ago and sales of plywood and logs to Japan and China are also rising. At the same time, imports have begun to recede. For example, imports of printing and writing paper, mainly from Scandinavia and Latin America, declined by 22 percent in the first half of 1986 compared to the same period in 1985.

The problems plaguing the industry's growth, however, will continue for several years. Foreign producers (Brazil, Chile, Spain and Portugal) have developed sizable paper industries of their own, and increased their share of the world market. New materials are also invading the market. Polyethylene plastic is rapidly replacing unbleached kraft paper for sacks. Other market losses have resulted from the increasing use of telecommunication devices that transmit information electronically. Nevertheless, the U.S. is the largest producer of primary paper and products, producing over 35 percent of the world's total supply. The industry continues to be in an excellent position

to serve its domestic market and to compete aggressively in foreign markets.

Printing and Publishing

The U.S. printing and publishing industry is the largest in the world, comprising 53,000 establishments and employing 1.3 million people. The demand for U.S. printed products rests on a number of demographic and economic factors, but particularly on business confidence, as evidenced by advertising expenditures and gains in disposable income. Other factors include population growth, household formation, educational attainment and increased personal consumption expenditures. In view of the favorable outlook of these factors, industry output are expected to grow at an average rate of 3.6 percent in 1987, following an estimated 2.9 percent rise in 1986. Sales of printed products should rise next year, with the increase being led by advertising in newspapers and magazines.

Technological change has affected virtually every phase of the industry's operations, thus increasing efficiency in production and delivery. Productivity increases are especially noticeable in typesetting and pre-press operations of many newspaper and commercial printing firms. Investment in equipment and machinery has increased production with minimal additions to payrolls. But the challenges facing the industry are many. Although the electronic media continues to make inroads on the consumers' attention, the print media have many advantages over T.V.s, videos and radios, including portability, low cost, accessibility and storage.

While the focus of most U.S. printing and publishing firms is on serving the domestic market, the industry is a net exporter of printed matter and the second largest exporter in the world behind West Germany. Shipments of printed matter destined primarily for Canada, England, Australia and Japan are expected to total $1.5 billion in 1987.

Chemicals and Products

The chemical industry is expected to outperform most other nondurable manufacturing industries next year as industrial output rises by 4 percent. Employment should increase by only one percent as companies hold the line on payrolls in order to contain costs. The strength in the automobile, housing and defense sectors, the industry's major markets, will continue to buoy chemical production, particularly in synthetic materials, which are expected to enjoy a 6 percent increase in production next year.

Strength in the industry's key sectors (basic chemicals, synthetic materials, drugs and paint) will offset weakness in other categories such as agriculture and industrial organic chemicals. Industrial gas and epoxy resin producers that supply the automobile and textile industry should experience a 3.0 percent increase in demand in 1987. Many chemical producers have entered into new and highly specialized profitable markets. Dow Chemical is developing specialized plastics; Hercules produces graphite fibers for the aerospace industry; and Union Carbide is expanding its industrial gases division. The move into specialty chemicals has coincided with a retreat from commodity chemicals production. Dow Chemicals abandoned its polyethylene complex in Saudi Arabia and Monsanto dropped its commodity petrochemical business. Consumer demand will account for some of the industry's strength expected in 1987 as the output of both soap and toiletries is expected to rise by 3.0 percent. Next year will continue to be bleak for producers of pesticides, fertilizers and other agricultural chemicals because of the depressed state of the farm economy.

Thanks to a much stronger cash flow and stringent cost-cutting measures, the debt position of the major chemical companies is much improved. Nevertheless, companies were saddled with increased operating costs as a result of stricter environmental and safety rules. This year, however, there were large increases in research and development to improve efficiency and create new products, thereby increasing competitiveness in world markets. The industry has suffered from global excess supply and intensifying foreign competition, especially in basic petrochemicals as low-cost producers from Saudi Arabia and Canada penetrate traditional U.S. markets. Further, import penetration in autos, appliances, electronics, computers and apparel has reduced these industries' domestic demand for chemicals. Exports fell by an estimated 3.7 percent this year while imports continue their rapid climb, resulting in a decline in the chemical trade surplus for the fifth straight year. However, the drop in the value of the U.S. dollar should help stabilize the chemical trade situation by stimulating export sales and slowing down the rise in imports.

Petroleum Products

The petroleum industry is continuing to adjust to long-term changes in the demand for its products. Industry production is anticipated to increase by 3.3 percent in 1987 while employment rises by 3.5 percent. The number of rotary rigs in use and the number of oil and gas exploratory and development wells has fallen to the lowest levels in years. Indeed, U.S. oil and natural gas drilling activity is the lowest since 1943.

Companies continue to restructure and streamline operations in order to adjust to the long-term changes in the marketplace. All major companies are selling off assets, paring unprofitable operations, consolidating markets and adopting other cost-cutting measures. The massive restructuring has been prompted not only by the slide in

oil prices but also by such factors as the need to cut huge corporate debt loads. Energy conservation is probably the single most important factor affecting the financial fortunes of oil companies today. Moreover, imports are hurting domestic refiners who are struggling to maintain profitable production levels. Mergers and joint ventures continue to reshape the industry as firms realize it is cheaper to increase crude oil reserves via acquisitions than to engage in costly exploration and drilling. Baker International, for example, is merging its drilling businesses with Newpark. Hughes and Dresser have formed a partnership of their pumping services subsidiaries. Overall, capital spending in the industry is expected to rise about 1.3 percent in real terms this year.

The companies that have diversified outside the production and marketing side of the energy business reported large earnings this year. Mobil has been been relying on its tanker and chemical operations and Amoco, Arco and Royal Dutch are depending on their petrochemical units to earn profits.

The Independent Petroleum Association reports that U.S. crude imports of oil have increased by 69 percent this year compared to 1985. The surge in imports was in reaction to declines in oil prices which prompted a rebuilding of U.S. oil inventories. The electric utility industry is expected to see a 20 percent increase in growth next year as the industry switches from more expensive natural gas to oil. Petroleum consumption should increase by 2 percent in 1987, with the largest gains occurring in the distillate fuel oil and jet fuel categories.

Rubber Products

The rubber products industry is expected to enjoy a turnaround in output growth next year. Propelled by strong demand generated by the housing, appliances and auto markets, the industry should see production increase by 5.6 percent in 1987. There continues to be a long-term shift away from rubber towards plastic products as they are less expensive to process. As a result, production of plastic products is expected to provide the bulk of the industry's strength, rising by 6.2 percent in 1987 while the output of other rubber products (excluding tires) rises by only 0.6 percent.

Over 70 percent of the synthetic rubber produced is consumed in the manufacture of tires and other rubber components for the auto industry. The worldwide shift to radial car tires in the early 1970s gave a new lease to the life of the natural rubber industry since radial tires require more natural rubber in their blend than do crossply tires. However, since radial tires last longer, the demand for replacement tires continues to decline. But, radial tire imports from Mexico, Brazil, Japan, Korea and other Asian countries have continued to soar, accounting for over 25 percent of the domestic market. As a result, producers are concentrating on markets for specialty rubbers (fluorocarbons, silicones, polysulfides, acrylic rubbers, and polyesters) which are increasingly being used in automotive applications.

In 1986, the industry was characterized by reduced demand, severe import competition, depressed prices and excess capacity, despite numerous plant closings in the last decade. B.F. Goodrich and Company shut two of its remaining four tire plants and abandoned production of farm tires. Firestone Tire & Rubber Company closed its Georgia factory and has phased out passenger and truck tire production. Companies continue to reshape their business in order to improve productivity, reduce costs and compete more effectively abroad. B.F. Goodrich and Company recently restructured its polyvinyl chloride and tire business in order to cut costs and streamline operations. Firestone increased earnings last year by selling its radial truck tire plant to Bridgestone Corporation, its Japanese archrival, and then buying tires made in that same factory for resale in the U.S. Manufacturers are concentrating efforts towards more profitable product lines, in particular high performance tires. Goodyear leads the industry in sales of these "upscale radial" tires to both original equipment and replacement markets. Companies are also focusing on producing specialty tires, such as aircraft tires, where imports have not yet made inroads. The recent merger of B.F. Goodrich and Uniroyal is the latest consolidation in the industry, and will account for 18 percent of the domestic market for car and light truck tires.

Prospects for the industry are expected to improve next year. The decline in the value of the dollar should bode well for domestic producers expanding into foreign markets. Although exports are projected to increase by 2.2 percent in 1987, imports will continue to climb. Lower oil prices have also proved a boon in reducing the cost of making tires and sparking more automobile travel. Demographic changes, consumer attitudes and changes in tire and transportation technology will continue to shape the future of the rubber products industry.

Leather and Products

The outlook for the U.S. leather and products industry appears brighter than it has been for years. Although the U.S. is one of the principal suppliers of leather to world markets, the proximity to raw materials has not helped the domestic fabrication industry in its struggle with foreign competition. The industry continues to be besieged by imports, which now account for 52 percent of domestic consumption of leather goods. With the exception of tanning, all sectors of the industry are labor-intensive. As a result, lower labor costs in many developing countries such as Mexico, Brazil and Taiwan, give foreign suppliers a substantial cost advantage. The developing countries' 1986 share of total U.S. imports of leather and products is expected to reach 73 percent.

The leather footwear industry, which labors under a 51 percent import penetration ratio, is composed primarily of privately held, family businesses. Despite such intense foreign competition, U.S. exports of leather footwear have enjoyed substantial increases during the past two years. The rate of growth of imports of this category of leather products has also increased but at a much slower rate than in previous years.

Although hundreds of plants have been closed during the past two years and employment has declined drastically, the remaining companies have streamlined operations, cut costs significantly and relocated some portion of production to low-cost overseas facilities. Manufacturers have also shifted production to higher-valued products and are trying to carve out market niches for themselves. Companies such as Interco have also begun diversifying into areas such as apparel and furniture in order to boost earnings.

Only the large, highly capitalized companies, however, will be able to afford investment in new technologies, especially robotics, that could narrow the disparity in labor costs between many foreign suppliers and U.S. producers. Consequently, many of the small producers will continue to be absorbed by larger firms during this period of industry consolidation and contraction. Overall production is expected to rise by 0.3 percent in 1987, after declining 8.8 percent this year. Reflecting the industry's shrinkage, total employment will fall by 5.9 percent this year but increase slightly in 1987.

LATIN AMERICAN DEBT: FLIRTING WITH DISASTER

by
Graciela Testa-Ortiz

The heavily indebted nations of Latin America are facing an insolvency crisis that cannot be resolved with IMF (International Monetary Fund) bridge loans. Today, four years after the debt problem was recognized, it remains as pressing a danger to the world's financial system as it was in 1982. In the process of complying with austerity measures designed to generate trade surpluses and earn the necessary foreign exchange to service the debt, economic growth and real wages have plunged in the Latin American nations. However, despite all the efforts, not only has the situation not improved, but IMF projections show that the problems (i.e., low economic growth rates and large debt burdens), will continue during the next five years.

The problems faced by the indebted developing countries have, so far, only been a matter of discussion in international financial and academic circles. Most Americans incorrectly believe that it is of very little relevance to them; there has been an almost complete lack of interest on the part of the American business community regarding this topic and its eventual resolution. Yet, the problems of the debtor nations have already cost many American workers their jobs and American businesses their markets. This paper details the channels through which the U.S. economy has been affected by the debt problems of our Latin neighbors and the results that have been achieved by the debt management strategy employed thus far. It then addresses the issue of default: the likelihood of it occuring and the impact it would have on the U.S. economy. The final section analyzes alternative long-range solutions to the problem.

Who Are The Indebted Nations and Why Are They So Important?

By far, the largest concentration of problem debtors is in Latin America. According to the IMF's classification, ten of the fifteen most heavily indebted nations—Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela—are Latin American republics (the remaining five nations are the Ivory Coast, Morocco, Nigeria, the Philippines and Yugoslavia). Not only does the list of Latin American debtors include all the major regional economies but, with the exception of Colombia, they all fit the IMF's definition of countries with recent debt servicing problems. That is, most of these countries have incurred debt service arrears during 1983–1984 or rescheduled their debt since 1982.

Aside from their obvious strategic importance, our Latin American neighbors have historically been an important source of demand for U.S. goods and services, ranking third in market importance behind Western Europe and Canada. The retrenchment in their economies which resulted from the debt crisis, has seriously curtailed their ability to import U.S. products, exacerbating our foreign trade gap. U.S. merchandise exports to Latin America, which accounted for 18 percent of U.S. exports of merchandise in 1981, fell to a low of 12.7 percent in 1983 during the worst of the debt crisis. Although they subsequently recovered, and as of the first half of this year averaged 13.7 percent of total exports, the ratio remains significantly below that of the first two years of the 1980s. In absolute terms, U.S. exports of merchandise to the region dropped by $12 billion between 1981 and 1985, accounting for over 50 percent of the total decline in merchandise exports during that period.

In an effort to raise the foreign exchange needed to service their mounting debts, the Latin American economies successfully increased exports. U.S. imports of merchan-

dise from Latin America rose by $7 billion between 1981 and 1985. As a result of the decline in Latin American imports from the U.S. and the increase in their exports to this country, the U.S. merchandise trade balance with the region swung from a $3.7 billion surplus in 1981 to a $15.3 billion deficit in 1985. Trade in services, where the U.S. has historically enjoyed a comfortable surplus, was also affected. The balance on services trade with Latin America fell from a $17.5 billion surplus in 1981 to $8 billion in 1985 (see Table 1).

TABLE 1

U.S. TRADE WITH LATIN AMERICA

($ Billions Unless Otherwise Noted)

	1980	1981	1982	1983	1984	1985
EXPORTS						
Merchandise						
Total	224.3	237.1	211.2	201.8	219.9	214.4
Latin America	38.8	42.8	33.2	25.6	29.8	30.8
(% of Total)	17.3	18.1	15.7	12.7	13.6	14.4
Services						
Total	118.2	138.7	137.5	131.4	140.2	144.1
Latin America	28.0	37.1	37.9	32.1	34.5	32.2
(% of Total)	23.7	26.7	27.6	24.4	24.6	22.3
Memorandum: Exports of Goods and Services to Latin America	66.8	79.9	71.1	57.7	64.3	63.0
IMPORTS						
Merchandise						
Total	249.8	265.1	247.6	268.9	332.4	338.9
Latin America	37.5	39.1	38.6	42.8	48.4	46.1
(% of Total)	15.0	14.7	15.6	15.9	14.6	13.6
Services						
Total	83.2	96.9	101.3	101.5	122.0	122.3
Latin America	15.5	19.6	23.5	21.3	26.6	24.2
(% of Total)	18.6	20.2	23.2	21.0	21.8	19.8
Memorandum: Imports of Goods and Services to Latin America	53.0	58.7	62.1	64.1	75.0	70.3

Source: U.S. Department of Commerce, *Survey of Current Business*, various issues.

While part of the decline in U.S. exports to this region can be explained by the appreciation of the U.S. dollar, which reduced the competitiveness of U.S. exports worldwide, this performance is particularly worrisome because it represents a sharp reversal of the previous trend. Between 1978 and 1981 merchandise exports to Latin America rose by 94.3 percent, one-and-a-half times faster than exports to the rest of the world. Since 1981, however, exports to Latin America have fallen four times faster than exports to the rest of the world.

The decline in exports to Latin America has affected some U.S. industries (which were already badly hurt by recession and the high value of the dollar) particularly hard. For instance, U.S. exports of machinery to Latin America, which reached $12.3 billion in 1981, averaged only $8.7 billion in 1985, a 29 percent decline. Similarly, exports of transportation equipment have declined by $2.3 billion (43 percent) since 1981, and iron and steel exports fell by $0.7 billion (70 percent). The decline in exports encompasses agricultural as well as nonagricultural trade. Sales of farm commodities to Latin America declined by $1.9 billion (33 percent) between 1981 and 1985 (see Table 2).

These declines in sales to our indebted Latin neighbors have translated into lost jobs. According to a 1983 study by Lester A. Davis, $1 billion in U.S. exports represented an average of 25,200 jobs in 1982. On that basis, the decline in exports of manufactures to Latin America since 1981 resulted in a loss of 302,400 jobs. More recently, University of Pennsylvania Professor F. Gerard Adams estimated that the swing in trade with Latin America cost the U.S. 780,000 jobs in 1984. Many of those jobs are in exactly those industries which were worst hit by the 1982 recession and the high value of the dollar.

Managing the Debt Problem: The Evidence So Far

Unfortunately, the debt crisis is far from being resolved despite the fact that the debtors have generally complied with IMF-sponsored austerity programs. What has re-

TABLE 2

U.S. EXPORTS TO LATIN AMERICA
BY COMMODITY GROUPINGS
($ Billions Unless Otherwise Noted)

	1980	1981	1982	1983	1984	1985	Percent change 1981-85
Agricultural commodities	5.7	5.8	3.9	4.6	4.7	3.9	-32.8%
Nonagricultural commodities	29.7	32.4	25.2	17.4	20.8	23.1	-28.7%
Food & Animals	4.5	4.7	2.8	3.6	3.0	2.6	-44.7%
Chemicals	4.9	4.5	3.7	3.3	3.8	3.7	-17.8%
Manufactured goods	4.4	4.7	3.2	2.1	2.4	2.5	-46.8%
Iron & Steel	1.1	1.0	0.6	0.3	0.3	0.3	-70.0%
Machinery	10.6	12.3	9.7	8.2	10.0	8.7	-29.3%
Transportation equipment	4.6	5.4	3.3	2.0	2.3	3.1	-42.6%

Source: U.S. Department of Commerce, *Highlights of U.S. Export and Import Trade*, various issues.

sulted from the strategies followed so far is significant in the negative impact that they have had on the economies of the debtor nations. In 1983, there was an outflow of capital from the indebted countries to their creditors in the West. According to the IMF's own projections, moreover, this perverse flow will continue into the 1990s, but the burden of debt will not be significantly lower. In the meantime, standards of living have fallen dramatically in the indebted nations.

Economic austerity is never a politically palatable option. The political pressures that rising unemployment and falling living standards create could topple any government, but particularly the fledging Latin American democracies. Most of those governments accepted these measures in the belief that they would be short-lived. That is, they expected that in the years following the initial crisis, international economic conditions would improve to the point where they would be able to increase exports to get their economies moving again, and relax the stringent measures. But, although interest rates have declined, relief is not forthcoming because, with the exception of the United States, industrial country imports from Latin America have remained low, commodity prices have not increased significantly, and protectionism has risen.

Although economic activity has recently picked up in West Germany and Japan, the U.S. is, far and away, the major market for Latin American products. Even while U.S. economic growth during the past year-and-a-half fell below initial expectations, the U.S. share of Latin American exports rose from 47 percent in 1985 to 52 percent during the first half of this year. But, while U.S. imports from Latin America have risen since the onset of the debt crisis and are now higher than they were in 1981, they slackened during the past year-and-a-half even while imports from other regions continued rising. Total U.S. merchandise imports rose by almost 12 percent between the first quarter of 1985 and the first quarter of 1986, but imports from Latin America fell by 5.2 percent. Other industrial countries are not picking up the slack. The share of Latin American exports going to Japan and Western Europe remains very low. And, West German data indicates that that country's imports from the developing countries fell by 15.2 percent during the first half of 1986 compared to a year earlier. Moreover, world commodity prices remain weak, reducing the earnings potential of Third World exports. And finally, industrial country protectionism has actually increased, albeit modestly. According to the World Bank, the share of developing country imports subject to nontariff barriers in industrial country markets rose from 19.5 percent in 1981 to 20.6 percent in 1984.

As a consequence of these many factors, the economic performance of the indebted less developed countries (LDCs) has been disastrous. Following the IMF's prescriptions, the problem debtors attempted to correct both the internal imbalances (budget deficits), and their external imbalances (trade deficits), by reducing (public or private) spending to free resources to pay their debts. This was accomplished through cuts in public spending and tax increases to reduce the fiscal deficit, and increases in exports and reductions in imports to reduce the trade deficit. To increase the external competitiveness of exports, the indebted countries allowed their currencies to depreciate. However, this made imported products more expensive in domestic markets and increased inflationary pressures. This was exacerbated by rapid increases in the money supply to finance continuing budget deficits. The result has been sharp increases in inflation and concomitant declines in real wages. In most LDCs, both growth in the money supply and inflation reached peak rates in 1985 (see Table 3). "In sum," comments MIT Professor Rudiger Dornbusch, "the needs to generate a large trade surplus and to finance large budget deficits combined to create inflationary recessions, cuts in real wages and the standard of living, unemployment, and severe cutbacks in investment."

Thus, while the industrial countries went into recession in 1982 and real GDP growth decelerated in the capital importing developing countries, real economic activity fell, both in 1982 and in 1983, in the most heavily indebted LDCs. In per capita terms, real GDP in the developing countries declined in 1981, 1982 and 1983, and in the fifteen most heavily indebted nations the decline continued into 1984. While 1985 brought a respite, 1986 promises to be another year of declining output and 1987 projections are for continued stagnation. In other words, per capita output in the indebted nations has been declining since the debt crisis began and there seems to be no relief in sight. Moreover, there has been a dramatic decline in the share of investment in GNP, further impairing prospects for future growth (see Table 3).

Yet there has been very little improvement in the external debt situation. Total external debt and debt service payments as a proportion of exports continued to rise during 1983–1985. The only significant improvement has been a sharp reduction in the share of short-term debt to total debt (see Table 4). However, all this means is that the day of reckoning has been postponed. A recent report by Morgan Guaranty Trust Company notes that, in the case of Brazil, recent debt reschedulings mean that its debt obligations will fall due at a rate of $10 billion a year between 1987 and 1989. The report concludes that, "By any reasonable standard, the present maturity schedule cannot be met."

The prognosis is not very good. In a rather too self-congratulatory manner, the IMF staff concludes, in its latest *World Economic Outlook*, that the measures instituted to manage the debt crisis "have had beneficial results, in terms of both strengthening the balance of payments and

TABLE 3

INDICATORS OF REAL ECONOMIC ACTIVITY

(Percent change except where noted)

	Average 1968-77	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Real GDP											
Industrial countries	3.5	4.2	3.3	1.2	1.4	-0.4	2.6	4.7	2.8	3.0	3.2
Capital importing LDCs	5.7	5.7	4.8	4.7	3.0	2.1	1.6	4.7	4.2	3.5	4.2
Western Hemisphere	6.0	4.1	6.0	5.3	0.9	-0.9	-3.1	3.1	3.8	1.6	3.5
Countries with recent debt servicing problems	5.6	3.5	5.4	4.6	1.2	-0.1	-2.5	2.6	2.8	1.9	3.3
15 Heavily indebted countries	6.4	3.4	6.1	4.8	0.7	-0.4	-3.5	2.2	3.1	1.5	3.3
Per capita GDP											
Capital importing LDCs	3.2	3.0	2.2	2.4	0.9	-0.3	-0.7	2.2	2.0	1.1	1.7
Western Hemisphere	3.6	1.1	3.7	3.0	-1.2	-3.2	-5.3	0.8	1.7	-0.6	1.3
Countries with recent debt servicing problems	3.3	0.8	3.1	2.2	-0.1	-2.5	-4.8	0.2	0.6	-0.5	1.1
15 Heavily indebted countries	3.9	0.6	3.7	2.6	-1.5	-2.8	-5.6	-0.2	1.0	-0.7	1.1
Broad Money Aggregates											
Industrial countries	n.a.	11.2	10.6	9.5	10.0	9.4	10.5	7.7	8.9	7.7	7.4
Capital importing LDCs	n.a.	29.6	35.5	27.0	27.9	17.3	10.1	10.6	7.7	n.a.	n.a.
Western Hempisphere	n.a.	53.3	60.9	53.4	71.3	73.2	104.2	141.5	143.1	n.a.	n.a.
Countries with recent debt servicing problems	n.a.	38.8	42.1	43.4	51.7	51.9	69.4	92.0	91.5	n.a.	n.a.
15 Heavily indebted counties	n.a.	45.1	51.8	50.5	60.9	61.6	88.1	117.7	120.6	n.a.	n.a.
Consumer Prices											
Industrial countries	7.1	6.9	9.2	12.1	9.9	6.9	4.4	4.4	3.8	2.6	2.7
Capital importing LDCs	15.2	18.7	21.5	27.1	26.0	24.5	32.7	37.4	39.3	25.9	13.7
Western Hemisphere	27.9	41.9	46.5	54.2	59.1	66.3	102.4	122.6	144.0	76.0	27.0
Countries with recent debt servicing problems	20.5	31.2	34.4	39.6	44.6	46.6	70.3	85.1	93.3	55.1	23.3
15 Heavily indebted countries	25.7	37.4	40.8	47.0	52.6	56.0	87.5	110.6	122.5	68.1	25.9
Gross Capital Formation											
(as a percent of GDP)											
Capital importing LDCs	n.a.	28.0	27.1	24.4	26.0	26.4	31.2	29.3	28.0	25.5	n.a.
Western Hemisphere	n.a.	24.7	23.0	23.4	22.8	20.9	17.4	17.2	17.9	17.4	n.a.
Countries with recent debt servicing problems	n.a.	27.2	25.6	25.4	25.3	22.6	19.1	18.0	18.0	17.5	n.a.
15 Heavily indebted countries	n.a.	27.0	24.9	24.7	24.6	22.3	18.3	17.2	17.2	16.8	n.a.

Note: For a definition of the countries included in each group, see footnotes to Table 4.
Industrial countries is average of seven major countries: Canada, U.S., Japan, France, West Germany, Italy and the U.K.

Source: International Monetary Fund, *World Economic Outlook, 1986*, Tables A5, A6, A7, A11, A13, A18 and A53.

the debt structure of the capital importing countries, and limiting the extent of the setback to domestic growth." But Fund projections show that, even under the best of circumstances, the problem is far from resolved. Table 5, which is entirely derived from IMF data, clearly shows that, not only will the debt burden of the major debtors remain threateningly high through the end of this decade, but, more menacingly, that the perverse transfer of capital from the poor countries to the industrialized West will continue.

In the case of the Western Hemisphere countries, the table shows that by 1991, net new capital inflows will fall short of interest payments by $18.7 billion, an improvement from the 1984 peak outflow of $27 billion but hardly a satisfactory result. The transfer of funds from the fifteen most heavily indebted nations, which is implied from the IMF data, paints an even more alarming picture. After peaking at $29 billion in 1985, the transfer of capital from this hard-pressed group of countries falls slightly through 1987 but rises again in the closing years of the decade (see Table 5).

More importantly, however, the IMF projections are

TABLE 4

INDICATORS OF EXTERNAL DEBT DEVELOPMENTS

(Percent)

	1973–74	1975–78	1979–80	1981–82	1983–85
External Debt (1)					
All capital importing countries (2)	95.8	120.1	115.4	135.7	158.2
Western Hemisphere (3)	139.8	187.6	190.3	238.0	285.3
Countries with recent debt servicing problems (4)	112.1	154.4	155.9	207.4	252.4
15 Heavily indebted countries (5)	123.9	169.2	173.7	231.3	280.1
Debt Service Payments (1)					
All capital importing countries (2)	12.7	16.7	18.1	22.1	23.0
Western Hemisphere (3)	21.5	33.3	36.3	45.4	43.2
Countries with recent debt servicing problems (4)	16.7	24.5	26.5	34.8	35.5
15 Heavily indebted countries (5)	18.2	28.6	32.0	43.2	42.6
Share of Short-term Debt in Total Debt					
All capital importing countries (2)	7.3	14.3	18.6	20.8	15.3
Western Hemisphere (3)	6.3	13.1	21.3	24.4	15.3
Countries with recent debt servicing problems (4)	10.0	15.1	20.2	23.5	15.8
15 Heavily indebted countries (5)	7.1	13.8	21.7	25.3	15.7

(1) As a percentage of exports of goods and services.
(2) Includes all developing countries except Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates.
(3) Thirty-three Western Hemisphere countries which account for 40.6% of the total outstanding debt of the capital importing LDCs.
(4) Defined as those countries which incurred external payments arrears during 1983 to 1984 or rescheduled their debt during the period from end-1982 to mid-1985. It includes 61 countries whose share of the total debt outstanding of all capital importing countries is 62.2%.
(5) Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ivory Coast, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia. These countries are responsible for 47.1% of the total debt outstanding of all capital importing countries.

Source: International Monetary Fund, *World Economic Outlook, 1986*, p. 88, Table 19.

based on rather optimistic assumptions. These include a continuation of moderate growth rates in the industrial countries; declines in real interest rates; improvements in the world price of nonoil primary commodities; a 3 percent increase in private lending to the capital importing countries; and increases in foreign direct investment in the LDCs. The indebted countries are also expected to continue to enact policies geared toward reducing internal and external imbalances.

The IMF projections show that the indebted LDCs will have to manage a very substantial reduction in their current account balances as a proportion of exports of goods and services. As Table 6 shows, the current account balance will need to decline to a proportion which is significantly below the historical average.

One must wonder how reasonable are the IMF's assumptions, particularly at a time when protectionist pressures appear to be a major threat to world trade. The projections assume that the indebted countries' exports and imports will both rise during 1986-1991, allowing for moderate increases in total output. But, these nations' ability to compete internationally, as reflected in movements in their terms of trade (the ratio of export prices to import prices) has eroded significantly since 1982, and the IMF anticipates further declines in 1988-91. The indebted LDCs also face the problem of rising competition from the Asian developing countries who have been able to carry similar debt burdens thanks to economic growth strategies based on open, free-market economies which have promoted export growth.

Therefore, if the indebted LDCs are unable to increase exports because of lackluster growth in the industrial nations, and/or continued (or increased) protectionism, and/or the continuing deterioration in their terms of trade, the only way they will be able to achieve the hoped-for reduction in their current account deficit is through further drastic reductions in imports. But imported inputs, particularly imports of capital equipment and new technology, are of paramount importance to the development strategies of the LDCs. Without a resumption of import growth, therefore, investment will continue to decline, their economies will continue to stagnate and the standard of living of their residents will continue to slide. The other side of the coin, of course, is that they will be unable to resume their role as an important source of de-

TABLE 5

IMPLICATIONS OF IMF PROJECTIONS FOR LDC CAPITAL TRANSFERS TO THE WEST–1986

($ Billions and Percentages)

	1982	1983	1984	1985	1986	1987	1989	1991
Western Hemisphere (1)								
Total Debt ($B)	328.8	340.4	351.4	373.1	383.3	390.7	409.9	429.7
Debt Ratio (2)	267.2	287.5	273.3	295.0	311.1	296.0	263.5	234.4
Debt Service ($B)	61.0	50.9	54.5	55.8	53.6	52.4	70.9	68.6
Debt Service Ratio (2)	49.6	43.0	42.4	44.1	43.5	39.7	45.6	37.4
Interest Payment ($B)	39.3	36.3	38.3	37.3	34.3	33.5	37.0	38.5
Interest Paymt. Ratio (2)	31.9	30.7	29.8	29.5	27.8	25.4	23.8	21.0
Net New Borrowing ($B)	41.8	11.6	11.0	21.7	10.2	7.4	19.2	19.8
Transfer ($B) (3)	2.5	-24.8	-27.3	-15.6	-24.0	-26.1	-17.9	-18.7
Transfer Ratio (2)	2.1	-20.9	-21.2	-12.3	-19.5	-19.8	-11.5	-10.2
Countries With Recent Debt-Servicing Problems (4)								
Total Debt ($B)	488.6	509.5	526.0	556.7	567.0	584.4	601.1	627.8
Debt Ratio (2)	234.5	252.3	244.2	260.6	275.4	261.0	232.7	206.4
Debt Service ($B)	79.6	69.5	75.6	78.8	77.6	77.9	98.4	97.0
Debt Service Ratio (2)	38.2	34.4	35.1	36.9	37.7	34.8	38.1	31.9
Interest Payment ($B)	48.5	45.2	48.7	49.1	47.4	47.0	49.9	51.4
Interest Paymt. Ratio (2)	23.3	22.4	22.6	23.0	23.0	21.0	19.3	16.9
Net New Borrowing ($B)	62.4	20.9	16.4	30.8	10.3	17.4	16.7	26.7
Transfer ($B) (3)	13.9	-24.3	-32.3	-18.4	-37.1	-29.6	-33.1	-24.7
Transfer Ratio (2)	6.7	-12.0	-15.0	-8.6	-18.0	-13.2	-12.8	-8.1
Fifteen Heavily Indebted Countries (5)								
Total Debt ($B)	377.0	391.2	404.0	416.3	427.9	441.1	448.6	433.4
Debt Ratio (2)	263.4	286.3	268.1	285.9	304.8	285.4	249.2	216.7
Debt Service ($B)	68.6	580.7	62.7	63.8	64.0	63.5	80.1	73.4
Debt Service Ratio (2)	47.9	425.0	41.6	43.8	45.6	41.1	44.5	36.7
Interest Payment ($B)	43.2	40.3	43.4	41.6	39.6	38.9	41.2	39.4
Interest Paymt. Ratio (2)	30.2	29.5	28.8	28.6	28.2	25.2	22.9	19.7
Net New Borrowing ($B)	48.7	14.1	12.8	12.2	11.6	13.2	7.5	-15.2
Transfer ($B) (3)	5.5	-26.2	-30.6	-29.4	-28.0	-25.8	-33.7	-54.6
Transfer Ratio (2)	3.8	-19.1	-20.3	-20.2	-19.9	-16.7	-18.7	-27.3

(1) See footnote (3), Table 4.
(2) Total debt, debt service, interest payments and transfer as a percent of exports of goods and services.
(3) Interest payments minus net new borrowing. A minus sign indicates an outflow of capital from the indebted nations to their creditors.
(4) See footnote (4), Table 4.
(5) See footnote (5), Table 4.

Source: Author's calculations derived from IMF, *World Economic Outlook*, Washington, D.C., April, 1986, Tables A54, A55. This table is an updated and expanded version of a table which appears in Harold Lever and Christopher Huhne, *Debt and Danger: The World Financial Crisis*, Boston: The Atlantic Monthly Press, 1986, page 66, Table 4.

TABLE 6

CURRENT ACCOUNT BALANCES AS A PERCENT OF EXPORTS OF GOODS AND SERVICES

(Percent)

	1968–77	1978–85	1986–91
Capital Importing LDCs (1)	-11.0	-12.0	-6.1
Western Hemisphere (2)	-18.0	-18.9	-4.5
Countries with Recent Debt Servicing Problems (3)	-14.0	-16.5	-4.4
Fifteen Heavily Indebted Countries (4)	-14.7	-17.8	-2.5

(1) See footnote (2), Table 4.
(2) See footnote (3), Table 4.
(3) See footnote (4), Table 4.
(4) See footnote (5), Table 4.

Source: International Monetary Fund, *World Economic Outlook, 1986*, Tables A35 and A54.

mand for U.S. exports. Moreover, even if all of the assumptions underlying the IMF's projections prove to be correct, real GDP growth in the capital importing countries is projected to average 4.7 percent in 1988–91 compared to 5.7 percent in 1968–72.

The IMF, in analyzing future prospects for these nations, notes that the indebted nations are "vulnerable to external factors, especially to a slowdown of growth in the industrial countries." And it admits that "for the highly indebted groups...there is little or no margin for downside developments: any substantial external setback will result either in a decline in the already very moderate growth projected under baseline assumptions, or in a

reversal of improvements in the external debt situation, or in some combination of the two."

Is Default Likely?

Thus we see that even under relatively optimistic assumptions, the indebted LDCs, and particularly the fifteen largest debtors (which include all major Latin American economies), cannot anticipate either a resolution of their current problems or any very substantial improvement. All along, however, their governments have imposed economic measures which have significantly reduced living standards. Is it reasonable to expect that politicians will continue to demand these sacrifices of their people when there is no end in sight? Clearly, if they did, it is unlikely that they would remain in power. Harold Lever and Christopher Huhne, in their recent book, *Debt and Danger,* make the obvious point that "If pushed to make a choice between servicing the banks' debt and serving their people, few, if any, of Latin America's leaders are likely to fail to serve their people." And, they conclude, "Default cannot be ruled out on either economic or political grounds."

Moreover, the conventional arguments against default do not stand up well to scrutiny. One of the major reasons for avoiding default is the prospect of a loss of future credit. However, if, as shown, IMF projections do not imply a resumption of net positive capital flows to the indebted LDCs even if they continue to service their debt and take the necessary policy steps to correct the present imbalances, what do they have to lose by defaulting? Obviously, they could only gain under present circumstances since the funds that are now going to service the debt, which represent a significant proportion of the product of their economies, could be used to promote domestic growth.

An important reason for not defaulting is the fact that trade credits would also dry up. This means that the defaulting nation would have to conduct all its trade on a cash or barter basis. To do so it would need to have enough reserves to meet the gap between export receipts and import payments (approximately six months of imports). Not surprisingly, the indebted LDCs have been increasing the ratio of reserves to imports of goods and services. And barter trade has also been rising.

In 1984, Brookings Institution economists Thomas Enders and Robert Mattione estimated the impact of default on Brazil, Argentina, Venezuela and Mexico and found that it would result in net gains for all four countries if the cost of repudiating the debt is 5 percent (that is, import costs rise by 5 percent and export receipts fall by 5 percent). Moreover, they found that if the cost of repudiation were 10 percent, Brazil, Argentina and Venezuela would still enjoy net economic gains.

Another reason why default would be to these nations' disadvantage is the threat that the assets held abroad would be seized to satisfy creditors' claims. However, most of these are private assets of individuals and corporations. It is unlikely that an American court would freeze the assets of private individuals to satisfy claims on the defaulting State. The only State assets of importance are foreign exchange reserves held at the Federal Reserve Bank of New York. But these funds have a certain measure of immunity. It is unlikely that the New York Fed would risk the liquidity crunch which would occur if the indebted LDCs felt that their reserve funds were not safe in deposit in New York. Moreover, if that were a real threat, the funds could be quickly and quietly moved to the safety of the Bank for International Settlements in Switzerland.

Nonetheless, and despite the potential gains, the Latin American debtors have gone to great lengths to repay the debt and disassociate themselves from the calls for default by Fidel Castro (who despite the rhetoric has continued to meet the payments on Cuba's foreign debt), or the limits placed on debt repayments by Alan Garcia, the President of Peru. They have also resisted the pressures for forming a debtors' cartel despite the increased leverage this might give them in bargaining with the creditor banks. But given the debt prospects outlined above, it is not out of the question to foresee a process of gradual unilateral limits on debt repayment, particularly in light of the political and economic pressures that the governments of the indebted nations are facing.

The Impact of Default

In mid-1984, Data Resources, Inc. performed a study of the likely impact on the U.S. economy of a two year moratorium on interest payments on the debt of the four major Latin American debtors (Argentina, Brazil, Mexico and Venezuela). The study, which assumed that the Federal Reserve would intervene to mitigate the domestic impact of such an action (a crucial assumption), found that real GNP would, nevertheless, decline and unemployment would rise as U.S. interest rates increased.

In 1982, in testimony before the House Banking Committee, then-Secretary of the Treasury Donald T. Regan outlined the channels through which the U.S. economy would be affected if the loans to the indebted nations had to be written off. There would a credibility-shattering loss of income to the banks whose capital/assets ratios would decline. The banks would, in turn, have to reduce overall lending, including lending to domestic individual and corporate borrowers. As the supply of loanable funds falls, interest rates rise. Higher interest rates would have a negative impact on all sectors of the domestic economy, including residential and nonresidential investment and purchases of consumer durables. As production in these

sectors falls, unemployment would rise and personal income would fall.

This scenario is not an extreme alternative considering that as of last March, the nine largest U.S. banks had loans outstanding to the ten major Latin American debtors equal to 71 percent of their total capital. Some, of course, are exposed more than others. According to Lever and Huhne, at the end of 1984, the exposure of one major U.S. bank to Mexico, Brazil, Argentina and Venezuela amounted to 173 percent of that bank's capital. And, other major U.S. banks are similarly exposed.

The problem is not confined to the United States. Of the four major British banks, two, Lloyds and Midland, have exposures of 165 percent and 205 percent of capital, respectively, to these same four countries. The international exposure of the non-American banks carries with it an additional problem, namely, that foreign banks' international loans are denominated in dollars, while their capital is in their national currencies. Thus, their foreign lending has been financed through dollar deposits. If concerns over possible LDC defaults were to lead to withdrawals of these dollar deposits, the banks would be unable to satisfy the demands upon them. According to Lever and Huhne, "the foreign currency deposits of the British banks–overwhelmingly in dollars–exceed the foreign currency reserves of the Bank of England by a factor of 35."

Proposed Solutions

As the foregoing has shown, the problems facing the heavily indebted nations, particularly those in Latin America, have not only caused widespread misery in those countries, but also affected U.S. production and jobs. Until recently, the debt problem was managed as if it were a liquidity crisis. Last October, recognizing that what we are dealing with in many of these countries is insolvency, Secretary of the Treasury James Baker put forward an important new initiative. Since then, several other proposals have surfaced, including one introduced in late July by Senator Bradley (D-NJ). This section details some of the advantages and disadvantages of several of the proposals to deal with the crisis.

A key requisite to the long-term solution of the debt crisis is the enactment of market-oriented policies in the debtor nations geared toward correcting the mistakes of the past. External factors (i.e., the 1979 oil price shock, the 1982 recession, high interest rates, and low commodity prices), only precipitated the crisis. The root cause of the current problem lies in decades of unremitting experimentation with socialism, central planning, state capitalism and government intervention in the economy; policies which have contributed to the impoverishment of millions of individuals and have squandered the vast resources of the continent. In contrast, the historical record demonstrates that those nations that followed free market development strategies have experienced rapid advances in their standards of living. Indeed, there are many developing countries (most of them in Asia) whose debt burdens are as high as those of the problem debtors but who, nevertheless, have been able to continue growing and servicing their debt. (For a discussions of the causes of the debt crisis, see the September, 1985 issue of *Economic Outlook*.)

The problem debtors face a major policy challenge which they have yet to fully recognize. This is true even in the case of Brazil, whose economy appears to have improved markedly since adjustment began. The problem debtors need to institute supply-side measures to improve private sector incentives. Such measures include: First, the reduction of fiscal sector deficits through reductions in government spending, not further increases in taxes. Major reductions in government involvement in the domestic economy would go a long way toward reducing the fiscal deficit. The economies of all the problem debtors are burdened by inefficient state enterprises which provide low quality service and operate at a loss, making government subsidies necessary to their continued operation. There is a direct relationship between the operating deficits of these state enterprises and foreign borrowing.

Second, it is imperative that fiscal deficits not be financed through the printing of domestic currency, a factor which has been a major contributor to rising inflation. Third, price controls should be dismantled to eliminate shortages and allow the market to function. The Brazilian government's Cruzado Plan (a price freeze), has been applauded for the impact it has had in reducing inflation. However, the price controls have resulted in shortages of many commodities. In a bizarre twist of events, the government is now subsidizing milk producers in an effort to counteract the shortages of milk which resulted from price controls.

Other measures which would improve the long range economic potential of the indebted nations are:

The elimination of exchange and trade controls and excessively high tariffs which distort domestic production by protecting inefficient domestic industries.

Realistic exchange rates to improve the international competitiveness of exports. The decontrol of credit markets to maintain appropriate interest rates that will stimulate domestic savings and prevent capital flight.

The establishment of producer prices, particularly for agricultural commodities, which reflect world market prices so as to increase incentives for domestic production.

The elimination of price subsidies to consumers.

The removal of restrictions on private foreign investment which could increase capital investment without implying increased debt.

The enhancement of private property rights.

No other economic indicator better reflects the inadequacy of the economic policies in the Latin American LDCs than the pervasiveness of capital flight. In many cases, if these funds could be repatriated a large proportion of the debt problem would be alleviated. Capital flight is not the fault of unpatriotic individuals but of government policies which discourage private investment in the domestic economy.

All of these policy recommendations are geared toward opening up the economies of the debtor nations. They reflect the acceptance of the fact that import substitution as a development strategy has failed, and recognize that those nations which based their development strategies on export-led growth are today thriving, in sharp contrast to the results obtained in Latin America. But, for such a strategy to succeed, the industrial countries must also do their part and recognize that in order for the indebted LDCs to be able to repay their debts they must be able to increase exports and increase their foreign exchange earnings. This cannot be accomplished if their access to industrial country markets is restricted. Thus, industrial countries must refrain from increasing barriers to exports from the LDCs and must work actively to defuse the protectionist bomb. For instance, the U.S. sale of subsidized wheat and beef has seriously affected the exports of some major debtors, most notably Argentina and Uruguay. In this regard, it should be noted that Argentina has threatened to reduce its repayments of debt to U.S. banks in proportion to the damage to its export trade resulting from U.S. dumping of wheat in international markets.

In addition, the industrial country governments should also extend new credits to the indebted LDCs. An effective way of doing this is through official export credit agencies whose activities could be coordinated with those of the commercial banks and the multilateral lending institutions. Finally, it must be recognized that the commercial banks operate within a regulated environment and that they must heed the rules set down by bank regulators. The relaxation of some of these rules would make it easier for the commercial banks to continue lending to the indebted LDCs. For instance, in the United States, bank regulators have allowed banks with a large percentage of energy and agriculture loans to reduce their capital/assets ratio below the required six percent.

But these reforms may take time to institute. Recognizing this, the Baker Plan attempts to deal with the immediate problems—severe recession and continued debt servicing problems—facing the major debtors. This proposal entails an increase in lending, both from commercial banks and multilateral institutions in return for commitments from the major debtors that they will enact the appropriate market-oriented policies enumerated above. The proposal also implies a greater role for the World Bank in directing the flow of resources to the developing nations, while the commercial banks are expected to significantly reduce the fees and commissions they charge for rescheduling due debts and reduce the interest rate mark-up on loans to problem debtors.

Although the creditor banks initially voiced their support for the Baker Plan, commercial bank lending has not increased. And while World Bank commitments have risen, disbursements have not increased significantly. With the exception of Ecuador, whose debts are tiny compared to those of Mexico, for instance, the Baker Plan has had no real successes since it was introduced almost a year ago. After stalling to the point that the negotiations were in danger of becoming unravelled, negotiators for Mexico, the multilateral institutions and the creditor banks reached an eleventh-hour agreement on a $12 billion rescue package. Everyone seemed to come out ahead from the negotiations: While the banks fended off Mexico's efforts to tie the debt to the price of oil, they did agree to provide a contingency fund which can be used if the Mexican economy does not achieve rates of growth in the three to four percent range (an implicit link to oil market developments). Mexico also got the banks to lower interest charges to 0.8 percentage points above the London interbank offered rate (LIBOR), a slight (0.3 percentage point) decline from the rate the banks were demanding initially, but one which, nonetheless, signifies a savings of $136 million in interest charges. And the World Bank has agreed to guarantee a small proportion of the loan—$500 million—an amount small enough to avoid charges that the Bank is "bailing out" the commercial banks. Everyone has saved face. Unfortunately, the real test of the success of the Baker initiative is not whether or not an agreement is reached but whether or not the Mexican economy can resume growing.

Mexico blames its current problems on the decline in world oil prices and the depressing impact this has had on the country's export earnings. However, Ecuador and Venezuela face the same problem but are not in such dire straits. Ecuador is the only success story in Latin America. Faced with a $1 billion shortfall in oil revenues, the Ecuadorian government responded by devaluing the currency and establishing a free-market growth strategy. As a result, the country is obtaining a $220 million loan arranged by Banque Paribas. The loan is $20 million over the amount originally requested because it was oversubscribed. According to *The Economist*, "This is the first time that a Latin American debtor which has gone through an IMF-sponsored restructuring has voluntarily been offered new commercial bank money." Venezuela,

on the other hand, whose government has yet to reform most of its interventionist policies has not been so "lucky."

Arguing that the IMF loans have only served to finance debt payments, not rekindle economic growth in Latin America, Senator Bradley has proposed an innovative scheme which recognizes that U.S. trade performance is tied to the debt crisis. His plan includes the annual convening of a trade/debt summit conference with participation by the representatives of the banks and the governments of all the major creditor nations as well as the indebted nations. At these conferences, creditors would offer debt and interest rate relief in exchange for debtor reforms designed to restore balance to trade, increase economic growth and strengthen the international financial system. Specifically, if debtors liberalize trade, enact policies which would reverse capital flight, encourage domestic investment, and promote domestic economic growth, then the creditors would (1) reduce interest rates by three percentage points, (2) write down and forgive three percent of the principal on outstanding commercial and bilateral loans, and (3) provide new multilateral project and structural adjustment loans amounting to $3 billion a year.

One of the arguments against the Bradley proposal is its impact on the commercial banks. The commercial banks should continue to be concerned about the likelihood of *de facto* default. Clearly, this alternative is much more dangerous than a gradual writing-down of debt. Moreover, the secondary market for Latin American debt is not emitting healthy signals. Table 7 shows that bank loans to Venezuela are being offered for sale at 77 cents to the dollar. At the other extreme, Peruvian debt is being offered at only 24 cents to the dollar, and Bolivian debt at eight cents. The commercial banks, however, are continuing to carry the debt on their books at 100 percent of face value. These discounts at which the debt is being offered are an indication of the riskiness of the loans.

TABLE 7
FOREIGN DEBT PRICES
(Cents per Dollar of Book Value)

Country	Offer Price
Argentina	67
Bolivia	8
Brazil	76
Chile	69
Ecuador	66
Mexico	62
Peru	24
Venezuela	77

Source: The Wall Street Journal, Tuesday, October 7, 1986.

To their credit, the commercial banks have, in some cases, reduced the interest rate mark-up. In addition to Mexico, restructuring of the Chilean debt was concluded at 1.625 percentage points above the LIBOR and the interest rate charged on the debt of the Dominican Republic and Uruguay is now 1.375 percentage points above the LIBOR. Moreover, in all of these cases and others as well, the commercial banks have allowed grace periods during which only the interest payments on the debt are due. Nevertheless, a gradual writing down of these loans seems to be called for, and, in fact, several European banks have already done so.

Another argument against the Bradley Plan is the fact that writing-off of debt will damage the credit ratings of the indebted countries for years to come. But, under current projections, the Latin American debtors are unlikely to receive enough new loans to cover interest payments. In addition, recent default experience shows that future credit will not dry up. In the 1930s, all of Latin America wrote down its debts, serviced them in local currency or simply failed to pay. According to Professor Dornbusch, in 1949 "...of the whole of Latin America's debt, half was in complete default, 45 percent was serviced with write-downs of principal and interest, and less than 3 percent was serviced on the original contracts of the principal outstanding. And Latin America prospered."

It has also been argued that the relief proposed by Senator Bradley is unnecessary because economic conditions have lately improved in many of these countries. This assertion ignores the fact that long-term progress will not be possible unless the Latin countries drastically reform their policies to allow the free market to work. It is true, for instance, that the Brazilian economy has recovered: real GDP growth exceeded 8 percent last year and industrial production rose by 12 percent. But the policies that have achieved these results are woefully inadequate and pose long-term threats to the economy.

For instance, inflation has been repressed through price controls but all indications seem to be that prices will surge once the controls are removed. The freeze has translated into shortages and price increases disguised as quality and quantity improvements. The budget deficit is now 5.4 percent of GNP, significantly higher than the 0.5 percent initially projected. And, monetary growth figures show that the deficit is being monetized. Moreover, the government has found a novel way of increasing taxes by imposing surcharges—euphemistically called "loans"—on the purchase of new and used cars, gasoline, airline tickets, and central bank sales of dollars for foreign travel. The proceeds from these "loans" go into the newly created National Development Fund which is to carry out social and infrastructure investment. These are hardly the types of policies which will enhance the operation of market mechanisms, increase economic incentives and efficiency, and reduce the level of government intrusion in the economy.

The most important issue, which the Bradley Plan ad-

dresses and the Baker Plan does not, is the fact that the negative transfer of funds from the indebted countries to their creditors in the West must come to an end if the economies of the debtor countries are to resume growing. In this regard, the World Bank staff, in an internal memorandum, has suggested that the Baker Plan could be improved by (1) extending it to six years for countries which meet certain criteria; (2) the World Bank should make concessions in the repayment schedules of certain debtors so as to assure a substantial positive net transfer of funds; and, (3) that commercial banks refrain from charging rescheduling and refinancing fees and reduce the interest rate they charge to the London interbank offered rate.

A third proposal attempts to deal with the problem of the existing debt on banks' books by making government guarantees available on condition that the banks would, each year, write down a portion of the existing debt. The government guarantees would, in effect, be a sort of insurance similar to that already provided by the Export-Import Bank, allowing the banks a longer period of time during which to write down the riskiest loans. Finally, a new issue of IMF Special Drawing Rights, which would be tantamount to increasing the world supply of money, could also be considered. But, since these issues are usually in proportion to a country's IMF quota, that is, its economic weight within the system, this might not significantly increase the funds available to the LDCs. However, if as has been proposed, the new issue were made available to the IMF itself, it would represent an increase in its resources which it could then disburse to countries undergoing adjustment programs.

Conclusion

The purpose of this article is to emphasize the need for cooperation in resolving the debt crisis. The commercial banks and the industrial country governments should assist the indebted nations in enacting the policies that will bring about a renewal of economic growth. If economic growth does not resume, the people of Latin America are likely to lose their patience with governments that have presided over years of economic austerity. If this happens, they are likely to bring into power a government that promises to repudiate the debt and concentrate on restoring growth and employment. Even if there are no changes in the governments themselves, political pressures would change the stance of those who are now continuing to negotiate. The recent agreement between Mexico and the banks shows that this is already happening. After its conclusion, Mexico's chief debt negotiator said in a speech that while his country wants to work within the system, "If cornered, [the] government has to put the interest of [its] people first." And, to the consternation of the bankers, he added, in response to a question about the relationship between interest payments and the political situation in Mexico, that "Now [paying interest] is an option; before, it was a fact." The specter of debt repudiation is real. The financial community cannot afford to ignore it.

The long term resolution of the debt crisis involves four key elements: (1) the resumption of positive net lending to the LDCs; (2) major policy shifts which will give greater play to market forces in the debtor nations and lay the foundation for sound economic growth; (3) continued growth in the industrial countries to assure that the debtor nations can earn the needed foreign exchange through export growth; and, (4) allowing the commercial banks sufficient time to write down the debt without it having a major impact on their capital/assets ratios. It is a long-term proposition which requires the collaboration of all the parties involved.

As the experience of Ecuador shows, market-oriented policies in the debtor nations will work (and they may work faster than is generally assumed). In addition, commercial banks have shown themselves willing to increase lending voluntarily once positive results are achieved, as the case of Ecuador also shows. However, interventionist government policies are so entrenched in many of the largest problem debtors that they cannot be immediately reversed without resulting in rising unemployment and running the risk of political upheavals. In such cases, it is imperative that the debtor governments be encouraged to take these steps. The best form of encouragement is the promise of a resumption in net positive transfers of funds, not the threat of poor credit ratings. The commercial banks must realize that they will be better able to ensure the repayment of interest and principal on these loans if the debtor countries are growing than if they are forced to continue enforcing austerity measures.

The commercial banks would be more willing to renegotiate LDC loans at lower interest rates (as both the Baker and the Bradley plan suggest), if the bank regulators were to ease some of the applicable rules. At the moment, however, the banks are penalized for lending new money. The U.S. Comptroller of the Currency has told the creditor banks that existing loans as well as new loans extended to several of the problem debtors should be treated as problem loans. This requirement is directly opposed to the notion prevailing both at Treasury and at the Fed, that under some circumstances, new lending can help improve the quality of the loans. The problem with regulations governing commercial bank lending to the LDCs is not peculiar to the United States. Bank officials in Canada, Japan and some European nations have required banks to increase their reserves against loans to several debtor countries. These requirements are another hurdle in the road to a resolution of the debt crisis.

It is time for the American business community to become involved in the debt debate so as to assure that a coherent set of positive policies emerges from all the solutions that have been proposed so far.

TRENDS IN COMMERCE
NOTES ON TABLE II
OCTOBER/NOVEMBER 1986

by
*Martin Lefkowitz**

Gross National Product (GNP) – The revised estimate of Gross National Product – the total value of goods and services produced in the economy – shows that second quarter GNP grew at a 0.6 percent annual rate. Final sales, after adjusting for inflation, grew at a vibrant 3.4 percent rate in the second quarter in contrast to a 1.3 percent decline in the first quarter, but the lower pace of inventory build-up, which had added $45 billion to first quarter GNP, subtracted $24 billion from second quarter output. Consumer spending remained strong, growing at a 6.2 percent rate in the second quarter. Despite a 2.3 percent drop in nonresidential fixed investment, producers' durable equipment purchases rose at an annual rate of 19.6 percent. The second quarter data continued to reflect a sharp deterioration in the nation's trade deficit, with exports declining by 9.4 percent while imports rose by 18.5 percent.

The Services Sector – Employment in service sector establishments increased by 150,000 jobs in September and is now 2.2 million jobs above its year-ago level. This compares with no change in jobs in the goods-producing sector over the last twelve months. Over the past year, the manufacturing sector has lost 114,000 workers. All of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services increased by 0.2 percent in August. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 27.1 billion in August, an increase of 18 percent from its year-ago level, and the best traffic month in the history of the industry. Over the past eight months, domestic passenger travel has increased by 11.7 percent and available seat miles were up 11.7 percent. International passenger traffic experienced a 0.6 percent decline in August compared to August of last year.

Money Supply – The nation's money supply – as measured by M1, currency in circulation plus demand deposits – increased by 1.7 percent in August and was 13.7 percent above its year-ago level. In the six months ended in August, M1 was up at an annual rate of 13.7 percent. This is considerably above the Fed's target range of three to eight percent.

Employment – The civilian unemployment rate inched back up to 7.0 percent in September from 6.8 percent in August, after declining for three consecutive months. Employment in service producing industries grew by 150,000 jobs in September, with much of the gain concentrated in business and health services, retail trade, finance, insurance and real estate. In September, civilian employment slipped back slightly to 109.9 civilian job holders. The U.S. economy first passed the 100 million job mark in 1981 and has created more than 10 million new jobs in a little over five years.

Consumer Price Index – The Consumer Price Index for all urban consumers (CPI-U) increased by 0.2 percent in August, following no change in July. Energy prices continued to be the largest moderating force while food prices and apparel costs accelerated. The index for food and beverage prices posted its largest increase in over two years, rising by 0.9 percent in August. Gasoline prices were down 4.7 percent in August and have dropped over 30 percent in the first eight months of 1986.

The Producer Price Index for finished goods increased by 0.4 percent in September after rising 0.3 percent in August. The September increase was, in large part, the result of a 3.7 percent increase in energy prices while food prices fell by 0.2 percent. During the last 12 months, finished goods prices at the wholesale level have declined 0.7 percent. The intermediate goods index rose by 0.5 percent, the first significant increase registered this year. Although energy prices led the upturn, there were large advances among metals and construction materials. However, the index for intermediate goods excluding energy and food edged up 0.3 percent. After falling 0.2 percent in August, the crude goods index rose 0.5 percent in September. Crude food prices declined 0.8 percent in September following a 2.5 percent increase in August and prices other than food and energy increased 0.5 percent.

Housing Starts – Privately owned housing units were started at a seasonally adjusted annual rate of 1,822,000 units in August, virtually unchanged from the July level. August housing starts were 5 percent above the August 1985 level. The data reflected a continued decline in apartment construction which many are attributing to tax reform legislation, while single-family home construction was up 3 percent. The Midwest reported the largest decrease in new home starts while the Northeast had an 18 percent increase for the month. Building permits, an indicator of future activity in the home building industry, were down 7 percent for the month.

Corporate Profits and Cash Flow – Corporate profits have been sluggish for the past year. While profits in-

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TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Aug 86	241.8	241.6	239.2	0.0	1.0
Gross National Product ($B)	II 86	4,175.6	4,149.2	3,965.0	0.6	5.3
Gross National Product (82$B)	II 86	3,661.4	3,665.9	3,567.6	0.1	2.6
Money Supply (M1) ($B)	Aug 86	687.8	676.1	604.8	1.7	13.7
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Aug 86	2,797.1	2,765.8	2,626.9	1.1	6.5
Personal Consumption Expenditures (82$B)	Jul 86	2,427.2	2,418.9	2,316.5	0.3	4.8
Disposable Personal Income ($B)	Aug 86	2,986.9	2,979.4	2,828.6	0.2	5.5
Disposable Personal Income (82$)	Jul 86	2,614.7	2,610.5	2,528.2	0.1	3.4
Personal Savings Rate (%)	Aug 86	3.1	4.0	4.1	−0.9[b]	−1.0[b]
Civilian Employment (millions)	Sep 86	109.9	110.2	107.8	−0.2[c]	1.9[c]
Civilian Unemployment Rate (%)	Sep 86	7.0	6.8	7.1	0.2[b]	−0.1[b]
Average Hourly Earnings	Sep 86	$8.81	$8.69	$8.67	1.4	1.6
Consumer Price Index (All Urban, 67 = 100) [a]	Aug 86	328.6	328.0	322.8	0.2	1.8
Purchasing Power of the Dollar (67 = $1.00) [a]	Jun 86	0.304	0.305	0.313	−0.3	−1.6
Prime Interest Rate (%) October 1, 1986		7.5	8.5	9.5	−0.5[b]	2.0[b]
Retail Sales ($B)	Aug 86	120.2	119.2	116.2	0.8	3.4
SERVICES SECTOR						
Employment in Services (Millions)	Sep 86	75.5	75.4	73.3	0.1	3.0
Consumer Purchases of Service ($B)	Aug 86	1,454.7	1,452.3	1,346.1	0.2	8.1
Consumer Purchases of Service (82$B)	Jul 86	1,185.8	1,180.1	1,141.3	0.5	3.9
Domestic Revenue Passenger Mileage Flown						
Major Airlines (Billions) [a]	Aug 86	27.1	25.7	23.0	5.4	18.0
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	II 86	231.3	224.3	213.8	3.1	8.1
Profits Tax Liability	II 86	93.3	89.1	87.1	4.7	7.1
Tax Liability as a Percent of Profits	II 86	40.3	39.7	40.7	1.5[b]	−1.0[b]
After Tax	II 86	138.0	135.2	126.7	2.0	8.9
Net Cash Flow	II 86	380.6	380.9	370.8	−0.0	2.6
Industrial Production (77 = 100)	Aug 86	124.8	124.6	124.3	0.1	0.3
Capacity Utilization Rate (Mfg.) (%)	Aug 86	79.6	79.5	80.3	0.1[b]	−0.6
New Housing Starts (thou. units)	Aug 86	1,822.0	1,815.0	1,737.0	0.3	4.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	II 86	169.1	168.8	165.9	0.1	1.4
Unit Nonlabor Costs (nonfarm) (77 = 100)	II 86	164.8	163.9	160.8	0.5	2.5
Producer Price Indices (67 = 100) [d]						
Crude Materials	Sep 86	275.5	275.5	291.8	0.5	0.4
Intermediate Goods	Sep 86	306.1	304.5	317.7	0.5	0.5
Finished Goods	Sep 86	286.6	287.2	290.0	0.4	0.5
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Aug 86	637.2	638.5	629.8	−0.2	1.2
Federal Gov't Gross Debt Outstanding ($B) [a]	May 86	2,035.6	2,012.6	1,758.3	1.1	15.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	II 86	363.0	374.8	370.0	−3.1	−1.9
Imports of Goods & Services ($B)	II 86	467.5	468.5	447.1	−0.2	4.6
Balance on Goods & Services ($B)	II 86	−104.5	−93.7	77.1	11.5	35.5
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Aug 86	179.1	179.5	169.2	−0.2	5.8

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] January data is a new series that is not comparable to previous data
[d] Index number not seasonally adjusted, percent change seasonally adjusted

creased by 8.1 percent between the second quarter of 1985 and the second quarter of 1986, they remained below the level of the fourth quarter of 1985. Economic profits, which take into account economic depreciation and adjust for changes in inventory valuation, were up 6.9 percent from their year-ago level. Net corporate cash flow, which includes depreciation allowances, increased nearly 2.6 percent from their year-ago level.

Industrial Production—Industrial production increased by 0.1 percent in August, following a revised 0.1 percent decline in July. Production in August was 0.3 percent higher than its year-ago level, but has declined by 1.1 percent since January. The August increase occurred in defense, construction supplies, nondurable consumer goods and nondurable materials. However, industrial production declined in the auto, steel, and electricity industries.

The August capacity utilization data shows that the nation's productive capacity has risen by an annual rate of 2.1 percent so far this year. The capacity utilization rate in manufacturing increased 0.1 percentage point, to 79.6 percent in August. The increase in the utilization rate occurred in the nondurable goods sector, while the durable goods sector experienced a decline. Between the second quarter of 1985 and the second quarter of 1986, durable goods capacity expanded by 2.6 percent and nondurable goods capacity increased by 1.3 percent.

Productivity—Nonfarm business productivity increased at a seasonally adjusted annual rate of 1.6 percent in the second quarter of 1986. This was about half the 3.3 percent growth rate reported in first quarter. Output rose by 1.3 percent while hours worked declined 0.3 percent. This was the first decline in hours worked since the fourth quarter of 1982 when they fell at a 3.4 percent rate. Manufacturing productivity rose at a 1.9 percent annual rate in the second quarter, and output declined by 1.5 percent, while hours dropped by 3.4 percent. This was the first quarterly decline in manufacturing output since the fourth quarter of 1982.

Interest Rates—The prime interest rate is currently 7.5 percent, 2.0 percentage points below its year-ago level. Three- and six-month Treasury bill rates were 5.2 and 5.4 percent, respectively, in early October. Thirty-year Treasury bonds, which traded at about 7.6 percent at the end of September, were up from 7.2 percent a month earlier.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, declined to 637.2 in August (1967 = 100), a 0.2 percent decrease from the previous month and 1.2 percent above the level of August 1985. Federal receipts for the first eleven months of fiscal year 1986 increased by 4.7 percent, while expenditures for the same period rose by 4.2 percent. The federal deficit for the first eleven months of fiscal year 1986 was $217 billion compared to $211 billion during the same period in fiscal year 1985.

Personal Savings—The personal savings rate was 3.1 percent of after-tax income in August, the lowest level since September 1985. Personal savings continue to remain at a relatively low rate from an historical perspective. However, business savings and the inflow of foreign capital appear to be making up for this anemic rate of savings by individuals.

Retail Sales—Retail sales rose by 0.8 percent in August, following a revised 0.3 percent increase in July. The August increase occurred despite the decline in gasoline sales which dropped by 1.8 percent due to lower prices, and food store sales which fell by 0.1 percent. The rise in retail activity was largely attributed to increased department store and auto sales.

Trade Deficit—On a goods and services basis, the trade deficit in the second quarter of 1986 was $104.5 billion, a significant jump from the $93.7 billion reported in the first quarter. The continued increase in the trade deficit occurred despite lower oil prices and a significant drop in the value of the dollar. The larger deficit was mainly the result of a decrease in exports. The U.S. merchandise trade deficit improved greatly in August shrinking by $4.7 billion. The decline in the deficit was due to an increase in agricultural exports and a significant decrease in imports of manufactured goods.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, declined 0.2 percent in August, following a one percent increase in July. The indicator has now declined in three of the last four months, leading many economists to believe the economy is on a slow growth path. Six of the 11 indicators available for August were down and five were up. Major contributors to the August decrease in leading indicators include contracts and orders for plant and equipment, building permits, and change in sensitive materials prices. The positive contributors were changes in credit outstanding, stock prices, money supply, new orders for consumer goods and materials, and average workweek.

REAL EARNINGS

In five of the world's largest OECD economies, average hourly earnings in manufacturing are rising faster than consumer prices. The only exception was in Italy, where over the past year, earnings have increased by 5 percent compared with a rise of 5.9 percent in consumer prices. In England and West Germany, growth in earnings has exceeded inflation by 5 percentage points over the past 12 months; in the U.S. and Japan, the gap is much smaller, with real earnings in these two countries having risen by 0.8 and 3.8 percentage points respectively.